Malaysia’s Policy Responses to the Panic of 1997: An Islamic Perspective

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A thesis submitted in partial fulfilment of the requirements of the University of East London for the degree of Doctor of Philosophy

School of Business and Law

April 2021

Abstract

This thesis explores the rationale behind the decisions of the Malaysian policymakers in response to the Panic of 1997, as Malaysia is the only country that had rejected the Washington Consensus while the rest of the crisis-affected countries pursued the orthodox policies. The thesis is to investigate whether the reasons behind the policy responses were due to adhering to the underlying principles of Shariah or mere political pragmatism.

Identified by the World Bank as a newly industrialising economy (NIE), Malaysia symbolises a developing country with an impressive growth rate in the last thirty years prior to the Panic of 1997. The transformation to a rapid economic growth in the 1980s and 1990s resulted from a change of policies regarding social and economic development. It was a widespread perception that the reason for Malaysia's rejection of IMF's involvement was primarily due to prevent any intervention in its existing social affirmative action policy known as the New Economic Policy (NEP). Concurrently, Prime Minister Mahathir's strong advocation towards the Islamisation policy had also made a significant impact in the development of Malaysia's policy framework.

The Washington Consensus via the IMF delegitimised the prevailing economic system in Southeast Asia by blaming the structural deficiencies in the financial and corporate sectors of the countries as the root cause of the Panic of 1997. The IMF believed that the Washington Consensus presents a model for institutional transformation. However, Malaysia had adopted the unorthodox capital control policy as a policy response, while the rest of the crisis-affected countries had accepted the Washington Consensus. The thesis adopts a historical institutional analysis in explaining the significance of the Islamisation policy and the importance of upholding the NEP and the likely impact of its reversal or revocation.

Keywords: Asian Financial Crisis, IMF, NEP, Capital Control, Policy responses, Islamisation.

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Abbreviations

2MP	Second Malaysian Plan
3MP	Third Malaysian Plan
4MP	Fourth Malaysian Plan
5MP	Fifth Malaysian Plan
AMC	Asset Management Company
ASEAN	The Association of Southeast Asian Nations
BAFIA	Banking and Financial Institution Act
BBMB	Bank Bumiputera Malaysia Berhad
BIMB	Bank Islam Malaysia Berhad
BMMB	Bank Muamalat Malaysia Berhad
BNM	Bank Negara Malaysia (Central Bank of Malaysia)
CDRC	Corporate Debt Restructuring Committee
Danaharta	Pengurusan Dahanarta Nasional Bhd
Danamodal	Danamodal Malaysia Bhd
East Asian Miracle report	The East Asian Miracle: Economic growth and Public Policy
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
GNI	Gross National Income
HPAEs	High Performing Asian Economies
IBA	Islamic Banking Act 1983
ICA 1984	Industrial Co-ordination Act 1984
IMF	International Monetary Fund
KLSE	Kuala Lumpur Stock Exchange
Tabung Haji	Lembaga Urusan dan Tabung Haji (Pilgrimage Management Fund)
MoF	Ministry of Finance
NEAC	National Economic Action Council
NERP	National Economic Recovery Policy

NEP	New Economic Policy
NIEs	Newly industrialising economies
NPL	Non-Performing Loans
OlC	Organisation of Islamic Cooperation
RM	Ringgit Malaysia
UMNO	United Malays National Organisation
USD	United States Dollar

Arabic and Malay terms and its meaning in English

Note: All Arabic or Malay terms that are used in this thesis will be italicised for ease of reference.

Arabic/Malay terms	**Meaning in English**
Allah	God (the only one)
Baitulmal	Treasury, exchequer, administration of vacant estate
Bumiputera (Malay)	The indigenous people of Peninsular Malaysia and East Malaysia (Borneo), literally means the 'sons of the soil'
Fatwa	Legal ruling issued by *Mufti*
Fiqh	Fiqh is based principally on interpretations of the *Quran* and the *Sunnah* and secondarily on *Ijma'* and *Ijtihad* by the *fuqaha* (Islamic jurist). While the *Quran* and the *Sunnah* are undisputable, *fiqhi* judgements may be modified to be adapt with different conditions.
Hadith	The term applied to specific reports of the Prophet Muḥammad's ﷺ words and deeds as well as those of many of the early Muslims.
Hajj	The final and fifth pillar in Islam, for the pilgrimage to the holy land, Makkah.
Halal	Permissible by Shariah
Haram	Forbidden by Shariah
Ijarah (Leasing)*	Refers to an arrangement under which the lessor leases equipment, building or other facility to a client at an agreed rental against a fixed charge, as agreed by both parties
Ijma	Consensus or agreement of the Muslim community
Imam	A religious leader in a Muslim community and the one that leads the congregation prayers

Islam	Submission to the will of God. Islam also means peace
Khalifah	Ruler or leader
Mazhabs	Schools of thought in Shariah
Mudharabah* (profit-sharing)	Refers to an agreement made between a party, who provides the capital and another party (entrepreneur), to enable the entrepreneur to carry out business projects, which will be on a profit sharing basis, according to a pre-determined ratios agreed upon earlier. In the case of losses, the losses are borne by the provider of the funds.
Mufti	Jurisconsult, qualified to issue a legal ruling i.e. *Fatwa*
*Murabahah** (Cost plus)	Refers to the sale of goods at a price, which includes a profit margin as agreed to by both parties. Such a sales contract is valid on the condition that the price, other costs, and the profit margin of the seller are stated at the time of the agreement of sale.
*Musharakah** (partnership or joint venture)	Refers to a partnership or joint venture for a specific business with a profit motive, whereby the distribution of profits will be apportioned according to an agreed ratio. In the event of losses, both parties will share the losses on the basis of their equity participation.
*Qard-al-hasan**	Refers to an interest free loan. The borrower is only required to repay the principal amount borrowed, but he may pay an extra amount at his absolute discretion, as a token of appreciation.
Qiyas	Analogy
Quran	Central religious text of Islam, believed by Muslims to be a revelation from God (Allah)
Sunnah	Collection of the words or acts of the Prophet or the *Hadith* which Prophet Mohammad ﷺ used to give moral guidance on many issues
Riba	Interest/usury prohibited by Islam

Takaful	Islamic Insurance
Ummah	*Ummah* means "community", the entire community of Muslims bound by ties of religion
Zakat	Obligatory charity taken from wealthy Muslims and distributed among a specified category of people

Note:

*Definition as provided by BNM’s Islamic Interbank Money Market

Quran Translation by Saheeh International.

Acknowledgements

BismillahirRahmanirRahim, in the name of Allah the Most Compassionate and the Most Merciful. First and foremost, I am indebted to Allah the Al-Mighty for granting me the patience and strength to finish this challenging project.

I would like to express my deepest appreciation to my distinguished supervisor, Professor Vassilis Fouskas, whose encouragement and expert supervision helped me complete this thesis. Thank you, Vass, for being my mentor and friend – I will cherish our coffee sessions at the cosy little café near the train station.

I would also like to thank my colleagues and friends at UEL for your support during the tough times in London - the year 2020 had overwhelmed us in many ways, good and bad. And a very special thanks to Avinder for just being there.

Invaluable gratitude goes to my father, Maj. Gen. Abdul Malek Shahar and mother, Datin Aishah, and my siblings Ali, Dilin, Amcik and Jimin, whose thoughts and prayers materialised into my good health and perseverance to complete this thesis.

Last but certainly not least, I would like to thank my wonderful husband of 18 years, Razdamsha (Adam), for his insurmountable patience of putting up with me and taking up the role of a single parent to our children during our unexpected separation in my final year. It seems customary for authors to thank their patient partner, but it is through Adam's love, unwavering support, and relentless encouragement that I was able to complete this thesis. And to my four lovely children Zara, Tisha, Masha and Ozil, thank you for being brave and patient during my "absence".

Thank you all - I could have not finished what I started without your love and support. Alhamdulillah.

Dedication

This thesis is dedicated to my parents.

Also, to my husband and children.

You are the lights of my soul.

CHAPTER 1: INTRODUCTION

1. Overview

The last century saw a significant transformation in economic philosophy from the principles of command to open market economies, that has reached its zenith with headway towards liberalisation and international integration of domestic economies. Gradual transformation from national to global markets had shaped the finance and business landscape with considerable challenges stemming from the requests for good economic management. The difficulties in economic management had shifted from straightforward policy responses in domestic crises to the more severe regional crisis that involved the entire global economy. The Asian Financial Crisis in 1997 (the "Panic of 1997" or the "Crisis"), which to a certain extent affected the world economy[1], has its roots in the period of financial turmoil that set off speculative actions in the foreign exchange market. These events indicated a defining moment for the Southeast Asia countries were praised for their swift economic growth, their rapid industrialisation progress and consequently improvement in their living standards. The spurt of industrial growth in the Southeast Asia region had also enhanced these countries to become models for other developing nations (e.g. South American countries). These countries had made surprisingly little growth despite being backed by the World Bank and IMF for many years for economic reform and structural adjustment (World Bank, 1997).

The Panic of 1997 could not have been anticipated because countries such as Thailand, Indonesia and Malaysia had displayed a remarkable track record of commercial growth, reinforced by economic stability and modest inflation rates, high savings rates, and a good growth in export. The potential incidence of a foreign exchange glitch in Asia was thus an absolute anathema as the state of their economies were believed to be profoundly stable. Table 1.1 shows the Southeast Asia countries with an average growth rate in terms of GDP per capita at 4-6%, for the period between 1960s to mid-1990s.

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[1] Corsetti, Pesenti and Roubini (1999) suggested an enlightened observation on the Panic of 1997, which triggered substantial changes in real exchange rates in the Southeast Asia, which led to worsening in the balance of trade the US and Europe by circa USD40-50 billion.

Table 1.1: Growth in Southeast Asian countries

	Real GDP per capita (USD1990 international)			Percent pa (%)	
Country/Year	**1950**	**1973**	**1996**	**1950-1973**	**1973-1996**
Malaysia	1,696	3,167	7,764	2.8	4.0
Philippines	1,293	1,956	2,369	1.8	0.8
Indonesia	874	1,538	3,464	2.5	3.6
Thailand	848	1,750	6,112	3.2	5.6
Singapore	2,038	5,412	20,983	4.3	6.1

Source: Asian Development Bank (1997) as adapted in Abu Bakar (2000).

1.1 Background and objective of research

The aim of this research is to work out whether Malaysia's policymaking decisions on the policy responses to the Panic of 1997 were influenced by the Islamic principles. This study shall seek to ascertain if the Malaysian policymakers were guided by certain rules that corresponded to Islamic principles or whether their decisions were solely due to political pragmatism.

There are many studies conducted on the policy responses to the Panic of 1997, particularly comparing Malaysia's policy responses to other crisis-affected Southeast Asia. Most of the researches were focused on the analysis of the capital control policy as well as the effectiveness of the IMF's intervention in countries like Indonesia, Thailand, and Korea. However, there are limited studies on the rationale of Malaysia's rejection of IMF's involvement in its economic recovery from the Panic of 1997.

There are several studies done on Malaysia's social and political landscape prior to the Panic of 1997. For instance, the work of Hashim (1995), Jomo (1999; 2004b), Noh (2012) and Yasin (1994) provided this research with valuable insight on the background of the political scene prior to the Panic of 1997, especially on the affirmative economic policy that was introduced by the government as a response to tapering down ethnic disharmony in Malaysia. This policy is known as the New Economic Policy (NEP) and will be further analysed in a slightly different context in chapter four of this thesis. The NEP is an important element of this research as it was commonly understood by Malaysians that one of the main reasons for Malaysia's rejection to any intervention by the International Monetary Fund (IMF) was due to upholding the NEP, a policy that was created as a response to a violent ethnic riot in 1969. The NEP had a two-pronged objective of "eliminating poverty and restructuring society to ensure economic and social fairness for the less fortunate ethnic community in Malaysia" (Rasiah and Shari, 2001). Pramanik (2002) had argued that the NEP is an affirmative action policy that is crucial for the unification of the multi-ethnic and set the groundwork for a contemporary Malaysian society for all ethnic background.

The Panic of 1997 initially began as a huge liquidity crisis but subsequently deteriorated into an economic and social catastrophe, caused by the withdrawals of substantial foreign capital from Southeast Asia. The attack on the Thai Baht in July 1997 turned into contagion and spread to the rest of the region. Preceding to the Panic of 1997, the capital flow into Asia grew abnormally, stimulated by both the requirement to deal with the access investment over savings and the prospect of greater returns for as well as the image of 'miracle' Asia. This sudden capital flight out of Asia aggravated the situation to the extent that was even more devastating to people's well-being than the Latin America 1980s crash (Wade, 1998a). Malaysia, including its neighbouring countries, namely Korea, Thailand, Indonesia, and the Philippines, were the worst hit by the Panic of 1997. Wade (1998) and Jomo (2006) had argued that Malaysia's neighbouring countries were coerced in accepting IMF's bailout and with it came harsh policies that had to be implemented by its recipient.

Malaysia had chosen to single out itself in the recovery from the Panic of 1997 by choosing an alternative method, while the rest of the Southeast Asia countries had accepted the aid from IMF, guised as austerity package (Wade, 1998a, 1998a, 1998c). There were mixed views on whether the approach adopted by Malaysia was more effective in its economic revival. On the contrary, IMF's strategy was criticised from across the political spectrum, as many believed that the IMF had misdiagnosed the situation and had lost credibility in the region (Jomo, 1998b; Wade, 1998a).

1.2 Research Design and Methodology

This thesis had adopted the historical institutional approach to explain Malaysia's political economy and understand Malaysia's policy response logic. Pierson's (2000, p. 251) definition of the historical institutional approach is the most relevant to this thesis. He summarised it as "specific patterns of timing and sequence matter; a wide range of social outcomes may be possible; large consequences may result from relatively small or contingent events; particular courses of action, once introduced, can be almost impossible to reverse; and consequently, political development is punctuated by critical moments or junctures that shape the basic contours of social life".

There a several definitions of institutions in historical institutionalism. North (1990, 1991) describes institutions as "humanly devised constraints that structure political, economic and social interaction" and that institutions involve both "informal constraints" like sanctions, tradition and taboos, plus formal rules "like law and property rights." He presents the metaphor that institutions are the rules of the game, and organisations are actors that give some form of sense to institutions. North regards the "kinds of information and knowledge required by the entrepreneur are in good part a consequence of particular institutional context." As such, the key to interpret institutions and institutional transformation lay in examining state's institutional traits (North, 1990, pp. 4–8).

Nonetheless, there are several other descriptions on institutions. Taking a somewhat different viewpoint, Hall (1986, p. 19) describes institutions as "formal rules, compliance procedures and standard operating practices that structure the relationship between individuals in various units of the polity and economy." Streeck and Thelen (2005, p. 9) define institutions as "building-blocks of social order." These building blocks of social order are social restrictions that impose expectations on actors with respect to behaviour and conduct. Institutions then form "mutually related rights and obligations for actors, help distinguish between appropriate and inappropriate, right and wrong, possible and impossible actions, and thereby organising behaviour into predictable and reliable patterns." (Streeck and Thelen, 2005, p. 9)

This thesis adopts North's (1990) interpretation of institutions because it covers a wider description of institutions. North further explained that public policy is a set of institutions because they design, modulate, and provide stability to interaction between actors. This is important because the affirmative action policy and capital control policy are central to this thesis. By applying the historical institutional argument, the thesis will show how public policies remained constant over time and helped establish multi-ethnic groups with independent sets of institutions.

Why does historical institutionalism approach the most fitting methodology to be adopted by this thesis? Mahoney (2001), Pierson (2004) and Thelen (2015) claim that historical institutionalism approach focuses to the historical process and emphasis on the theories of path dependence, increasing returns, timing and sequencing. There are 3 fundamental hypotheses to historical institutionalism.

First, the historical institutional approach believes that "political processes can best be understood if they are studied over time." (Pierson, 1993, p. 596). My research is an examination of the historical processes that led to the decisions behind the policy responses, which included the political framework prior to Malaysia's independence in 1957, the NEP as a consequent to the ethnic riot of 1969, and Mahathir's Islamisation policies since 1985 up until the Panic of 1997.

Second, a historical institutional approach treats "structural constraints on actors", especially those that derive from the state as "important sources of political behaviour." (Pierson, 1993, p. 596).

Third, the historical institutional approach deems that "detailed investigation" of vigilantly selected case studies provides a "powerful tool for uncovering the sources of political change."(Pierson, 1993, p. 596).

A notable work that discusses the historical institutionalist approach in considerable detail is Pierson's (2004) *Politics of Time*. Pierson (2004) points out that a state's differentiated political, social and economic nature is an output of the state's distinctive historical experience. Pierson suggests that a state's social, political, and economic transformation arises from gradual or incremental change. He elaborates that social processes undergo minor changes which may be insignificant when viewed from a short duration but could prove no less transformational when viewed from a longer time horizon. Pierson's contention is linked to concepts like path dependence, sequence, and timing. This is explained below.

1.2.1. Path Dependence, Timing and Sequence

A key concept in historical institutional analysis is path dependence, but this term has several various definitions. Mahoney (2000, p. 507) sees path dependence as "specifically those historical sequences in which contingent events set into motion institutional patterns or event chains that have deterministic properties." Sewell (1990, p. 263) defines path dependence as "that what happened at an earlier point in time will affect the possible outcomes of a sequence of events occurring at a later point in time." Levi (1997, p. 265) perhaps give a more cogent definition of path dependence - "Path dependence means that once a country or region has started down a track, the costs of reversal are very high. There will be other choice points, but the entrenchments of certain institutional arrangements obstruct an easy reversal of the initial choice".

Despite the different interpretations, a path-dependence analysis must have three major characteristics. First, the term implicitly includes the review of causal processes that are extremely susceptible to incidents that occur in the initial stages of an overall historical sequence (Mahoney, 2000, p. 510). Second, "path-dependence analysis subscribes to the idea that initial conditions do not guide the predictability of the final outcome" (Mahoney, 2000, p. 511). Third, a path-dependence analysis "takes the view, that once a contingent event takes place, the event sets into motion a series of processes and track a particular outcome" (Mahoney, 2000, p. 511). In a nutshell, path dependence means once a decision is made, a self-reinforcing mechanism kicks in where “each step in a particular direction makes it more difficult to reverse course” (Pierson, 2004, p. 21).

The research inquiry had two major concerns. One primary concern was to establish the relevance of path dependence - which is central to the historical institutional argument. As mentioned above, path dependence refers to causal processes that are sensitive to events that take place in the early stages of a historical sequence (Mahoney, 2000; George *et al.*, 2005). The other concern of this research was to account for the development of Malaysia’s plural society after nearly one and half century of colonial rule in the Peninsular Malaysia. This is not wholly a novel question as scholarly works on Malaysia such as Esma (1991), Gomez and Jomo (1999), (Hashim, 1995), Jomo (2003, 2004b) and Yasin (1994) all agree on the presence of Malaysia’s plural society and the existence of ethnic politics. The difficult question is whether these works differ, and how does one explain the policy responses that correspond to Malaysia’s plural society.

To address the above questions, this thesis suggests that ‘path dependence’ cannot be construed simplistically and that the Mahathir administration had some sort of short-term coherent policy to enable Malaysia’s different ethnic communities to develop exclusive governance systems that would have allowed for the creation of autonomous communities. This thesis argues that the Mahathir administration had a long-term plan for Malaysia. The administration was conscious that it was developing two autonomous races, the Malay and Chinese, with exclusive sets of institutions.

Reconciling the historical evidences and accounting for the formation of Malaysia’s plural society required moving away from a simplistic version of path dependence. It required questioning current literature on Malaysia regarding state formation. It also required an examination on the affirmative action policies, the NEP, and its subsequent variants. It further required piecing together works from various disciplines, namely history, politics, economics, public policy and even sociology. It was obvious that if there was a way out of this conundrum, understanding the affirmation action policy was central. One of the initial stages of this research was to understand the NEP. Works by Gomez and Jomo (1999), Hashim (1995), Md Mansur (2000), Milne (1976), Pepinsky (2013) and

Yasin (1994) offer initial insights to Malaysia's social and political landscape in the period prior to the NEP.

The research hypothesis is based on the two main policy responses that were unique and very crucial to Malaysia's recovery, which were the capital control policy and the restructuring of the entire financial system. Based on these two hypotheses, the research designed was focused on the following work:

i) The restructuring of the financial system was via the setting up of three companies i.e. Pengurusan Dahanarta Nasional Bhd (Danaharta), Danamodal Malaysia Bhd (Danamodal) and Corporate Debt Restructuring Committee (CDRC). Even though Danaharta was wound up in 2005, its operations were transferred to a newly set-up wholly owned government company known as Prokhas Sdn Bhd[2].

ii) A detailed analysis of the capital control policy that was constructed based on the policy dialogue between Mahathir and his unofficial economic advisor, Nor Mohamad and other members of the National Economic Action Council (NEAC). Apart from the collection of unofficial notes from the policy dialogues between Mahathir and Nor, minutes of meetings and the working papers of the Ministry of Finance (MoF) and Bank Negara Malaysia (BNM) were also analysed. Nor was appointed as Mahathir's unofficial economic advisor during the Panic of 1997. He was picked by Mahathir to help him with the Panic of 1997 as Nor was previously involved in a similar foreign currency deal while working with BNM. Chapters 5 and 6 detail the findings and analysis on the policy responses i.e. restructuring of the financial system framework and the capital controls policy.

The adopted methodology of this research is qualitative because of the epistemological and ontological assumptions of this study, which are exploratory in their nature. There are three rationale for a qualitative method. Firstly, practical issues will occur in the

[2] Prokhas' main function was the management and disposal of the residual assets transferred from Danaharta. Subsequent to 2005, Prokhas has been engaged by the Ministry of Finance to undertake special government projects. The access to data gathering that was provided during the research at Prokhas' office had made a significant impact to the researcher's understanding of the political manoeuvring and administration within the government departments and ministries.

employment of quantitative technique because the data quality fairly often disputable. In the Southeast Asia countries including Malaysia, credible statistical indicators are sometimes omitted or unavailable and the dimensions of some statistical data were frequently modified (Kaufmann, Kraay and Mastruzzi, 2003). Additionally, there is widespread scepticism over fiscal and monetary data as the statistical criteria were modified during the Panic of 1997 (Lee, 2004). Many analysts have uncertainties over the integrity of the data on the commercial and corporate sectors[3] (Duriau, Reger and Pfarrer, 2007).

Secondly, the effects of policy decisions cannot be impartially evaluated because these responses were in essence subjective in nature. It is usually challenging to quantify these responses that affect changes in policy and therefore, the political or religious influence of policy responses are often described in relative terms and not absolute (Lee, 2004). And lastly, the 'small N (*n*)' issue[4] is an interference in its application using the quantitative method. The small N applications are susceptible to bias or selection effect in certain cases and exceedingly challenging to derive to a statistically valid outcome from a low frequency of small N, even when applied in the simplest linear regression model (King, Keohane and Verba, 1994). With regard to the Panic of 1997, the maximum number of small N cases are four or five at best, which is not sufficient to ascertain a robust empirical finding.

Given this, the research methodology that was chosen for this thesis is via the qualitative method and it involves the critical analysis of the policy responses during the Panic of 1997. According to Pierce (2008, p. 45), "In the main, qualitative method is preferred because it is considered best suited to the study, understanding and explanation of the complexities of social and political life… researchers are better able to 'see the world through the subject's eyes'".

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[3] For example the NPLs data in Malaysia. BNM had relaxed the rulings for NPL, adjusting it from 3 to 6 months.This was the BNM/NEAC's attempt to rescue banks with debts from bankruptcy threats.

[4] The *small N* is the number of observations on which data must be collected.

The approach was to build up a historical narrative on critical elements prior to the Panic of 1997, elements that were unique to Malaysia as compared to its neighbours affected by the Crisis, especially Indonesia and Thailand. These elements consist of the evolution of the affirmative policy - the NEP, Mahathir's Islamisation approach and the NEAC. Data for this has been drawn predominantly from secondary sources and cross-checked by data from primary sources such as speeches and minutes. The collection of secondary sources included policy documents, economic reports (IMF, World Bank, MoF) and annual reports (BNM and Danaharta) that were sourced from the Malaysia government (ministries and agencies) and the National Archives in Kuala Lumpur. The primary reason for this is the data collected by governments and international organisations were of high quality as the data were compiled by experts using rigorous methods (Ghauri, Grønhaug and Strange, 2019).

Documents of historical nature such as annual reports, economic reports, press releases and minutes were obtained from Malaysia's national archives in Kuala Lumpur. Secondary sources are the official documents of the Economic Planning Unit (under the Prime Minister's department), the central bank (BNM), the Treasury (MoF) and the relevant government agencies set-up as the response to the Panic of 1997. Main data gathered consisted of the relevant policies and working papers, specific Statutory Acts enacted post Crisis, minutes of meetings, annual & operational reports, economic reports, and other official reports. These were reviewed and analysed to construct the narrative of the reaction to the Crisis. The aim is to construct a historical narrative of the policy responses based on the historical institutional analysis and the subsequent actions undertaken by the appointed agent of the Malaysian government.

The thesis will also attempt to explain or account for Malaysian government's or rather Mahathir's perspective on Islam by looking at the steadily growing political space that a particular understanding of Islam has occupied the Malay society over the previous century. The focus is the last twenty years prior to the Panic of 1997 years in particular, which coincide with the bulk of *Mahathir years*[5], but also with the period of

[5] Mahathir years defined by Malaysians, lasted for 22 years, from 1981 until 2003.

crystallisation of Islam as the major ethnic and even national political signifier in Malaysia.

1.3 Research Questions

In seeking to explain Malaysia's policy responses to the Panic of 1997, the research will attempt to answer the following questions:

1. What was the exact framework of economic policies in Malaysia?
2. What were the cultural and other motivations of the policymakers (in implementing the NEP) in response to the ethical riot and (in implementing the capital controls policy) in response to the Panic of 1997?
3. How did the different motivations of the different actors affect the policies in Malaysia?
4. How did the underlying principles of Shariah, if any, contribute to the eventual decision-making process in response to the Panic of 1997?
5. Were there any alternatives to the policy response logic? If so, did they fail?

1.4 Significant contribution of the Research

Whilst it has been established that the body of knowledge on financial crisis is as extensive as it is contentious, and the analysis on the Panic of 1997 is as voluminous as it is recurrent, not much analysis were completed prior to this thesis that relate particularly to the rationale behind the policy responses. Hence, this thesis focuses on the thought process of the policymakers and analyses them to see if the rationale behind their actions were due to the guiding principles of Shariah or merely political pragmatism.

As of to date, there is no discussion on the policy responses from the Islamic point of view and the examination of the rationale behind the policy decision makers' decision on the implementation of such policy responses. This thesis goes some way to addressing that shortfall in the literature by adding value to the existing knowledge in the areas of the policy responses of the Panic of 1997 from the Islamic perspective.

This study is not an attempt to solve long-standing debate concerning the risks of capital account liberalization, the virtues of capital controls, or the sources of Southeast Asia's remarkable growth. The assessment of these contentious issues is merely suggestive, and it draws rational conclusions based on data and available scholarly work.

1.5 Outline of Thesis

This thesis is divided into two main parts with six chapters. The first part is the groundwork of the thesis which consists of the theoretical framework and literature reviews (Chapters 2-4), while the second part presents the empirical analysis, contextualisation of the findings, and conclusion (Chapters 5-7). The outline of the thesis is laid-out below for ease of reference:

Chapter Two summarises the globalisation phenomena and its impact on developing countries before considering their relevance in the Malaysian setting. It also deals with the globalisation experience in Southeast Asia, comparing Malaysia to its neighbours. The second part explores Malaysia's globalisation experience and the backdrop of Malaysia's political situation that had led to the unique policy responses. Overall, this chapter outlines the evolution of the international political economy prior to considering the assimilation of Southeast Asia's economies in general and Malaysia, in particular. It also studies various processes of globalisation that were adapted corresponding to the individual country's unique social and political surroundings.

Chapter Three analyses the fundamental background of the Islamic principles applied to the economic system. The first section of the chapter reviews the ideological underpinnings in working out the social, economic, and financial system based on the doctrines of Islam and its challenges. It will then analyse the divine legislative framework that regulates the Islamic finance system in Malaysia that distinguishes it from conventional banking and finance. This analysis is important in understanding the significance of the law to the general Muslim community. The second half of this chapter gives the narrative on the history and early development of Islamic finance in Malaysia. It points out the importance of Islam in shaping Malaysia's social and economic policies as well as BNM's role in the establishment of a full-fledge Islamic financial system.

Chapter Four examines the rationale behind the creation of the NEP and its relevance to the Malaysian people. The first half of this chapter provides the fundamental background in understanding the social and political landscape in Malaysia. It analyses Malaysia's social structure preceding the NEP and the important historical events that compelled the ruling government at that time to establish an affirmative action policy which was the NEP.

The second part of this chapter is the process of legitimisation and implementation of the NEP throughout different phases of development plan. It continues further to analyse the seriousness of NEP's withdrawal, to the extent that the Malaysian government had resolved to defend such a policy at the risk of foregoing financial aid from IMF. Malaysia took the risk of going against the flow, while its neighbours took the much-needed support from the IMF.

Chapter Five analyses the findings on the banking reform initiatives initiated by the NEAC under the National Economic Recovery Plan (NERP). It will examine the rationale behind the NEAC's decision and the process of undertaking this strategy in stabilising the financial system in Malaysia. It will study in detail the establishment of the three special purpose government agencies that was set up to undertake this special task– Danaharta, Danamodal and the CDRC. The latter part of this chapter will briefly analyse the banking reforms that were undertaken by the other crisis-affected Asian countries as a comparative review. However, the banking reforms in these countries were part of the IMF's conditions for the financial aid that it had provided. The analysis will summarise the similarities and differences of the banking reforms approaches undertaken by these countries and their impact on the social and economic well-being of the countries.

Chapter Six explains the events that led to the decision on the policy in response to the Panic of 1997 and the restructuring of Malaysia's banking system. It examines the rationale based on events that took place behind the decisions that Malaysia took in its policy responses. It then continues to analyse selected policy responses that were in contrast to the responses to other Asian countries, such as Korea, Thailand, and Indonesia. While these countries carried out orthodox policies[6], Malaysia employed unconventional policies. In terms of macroeconomic stability, these countries stood to a pro-cyclical policy while Malaysia followed a countercyclical policy and the utmost distinction is in its foreign policy. Malaysia enforced capital controls policy with the establishment of a pegged system, whilst the rest of the affected Asian countries relaxed their regulations on capital account activities, switching to a free-floating system.

And finally, the concluding ***Chapter Seven***, ties the thesis together. This chapter revisits the research questions and reviews the answers to those questions by summarising the background to the thesis, the overall analysis and conclusion to the findings.

[6] Orthodox policies are a set of policies that are initiated by the Breton Woods institution to restore macroeconomic stability. Such policies typically comprises of drastic cuts in public spending, curbing of fiscal deficit, tightening of domestic credit growth and hiking interest rates to control inflation (Muqtada, 2010).

CHAPTER 2: MALAYSIA'S GLOBALISATION

> "Asia's experience of globalisation has not convinced it that this is the answer to economic ills or the vitamin for economic growth, at least the kind of globalisation that is being promoted by the rich western countries. Globalisation need not be about free capital flows only. There can still be globalisation, but it should not be absolutely free, it should not be purely market driven. Regulated globalisation can still be compatible with the idea of globalisation."
>
> Mahathir (2002a)

2. Introduction

This chapter outlines the characteristics on the phenomena of globalisation and its impact on developing countries before deliberating their significance in the Malaysian context. This analysis is important in providing the understanding to the rationale behind Malaysia's policy decisions. Despite being a relatively small economy, Malaysia had risked the wrath of dominant world organisations like the IMF whilst simultaneously agitating the increasingly influential global financial players. This chapter then briefly reviews the World Bank's special report on the East Asia miraculous economic growth since the 1960s up until the early 1990s, a period just before the onset of events leading to the Panic of 1997. It also covers the globalisation experience in Southeast Asia, comparing Malaysia to its neighbours. The second part examines the Malaysian globalisation experience and the background of Malaysia political landscape that had resulted in Malaysia's distinctive policy responses, albeit the criticism, externally and domestically. Though the motivation behind Malaysia's economic policy responses were controversial, yet the fact that such reactions are feasible at all indicates a significant insurgence in the outlook of political economic progress.

Overall, this chapter outlines the metamorphosis of the global political economy prior to considering the integration of East Asia's economies in general and Malaysia, in particular. The analysis focuses on both the benefits and the damage that the globalisation phenomena had brought onto the developing economies. The concept of globalisation has immediately developed into an accepted part of academic discourse, and its ubiquitousness is a manifestation in the absence of an alternative perspective. Although there is a universal understanding that dramatic developments have transpired in the international framework, the scope and magnitude of such transitions are much more controversial. It also looks at certain processes of globalisation that were adjusted according to the individual country's distinctive social and political environments.

Globalisation has different meaning to different people. For the majority of Muslim communities, globalisation is often categorised as the process of Westernisation as the dynamic force behind it are the Western countries (Murden 2002). Whilst, for the developing countries, globalisation typically means economic colonisation by the hegemonic powers that control organisations like the IMF and World Bank. As Stiglitz (2002, p. 7) pointed out that "even when not guilty of hypocrisy, the West has driven the globalization agenda, ensuring that it garners a disproportionate share of the benefits, at the expense of the developing world." However, the definition of globalisation that is relevant in this analysis is globalisation of the financial markets or financialisation. As explained by Lapavitsas (2013, p. 13), "financialization is reminiscent of globalization' and globalisation refers to 'the growth of the world market, the expansion of international financial markets, the increasing interpenetration of economies via foreign direct investment, the rise of global flows lending, and a host of related phenomena in the world market during the last three decades." Whilst, Fouskas and Gokay (2012, pp. 16–17) supports the claim by Albo et al. (2010, pp. 34–35) that "financialization gives rise to such financial volatility that crises actually become one of the developmental features of neoliberalism, and this reinforces rather than undermines the central position of financial interest in capitalist power structures."

Given this, Malaysia's viewpoint on globalisation as a developing country in Southeast Asia with a majority Muslim population was skewed towards the negative effect that globalisation would bring to the country and its people, especially under the Mahathir administration. Mahathir stated that "the globalisation of the world has changed the whole equation. We may not want to accept the changes. We may want to stay out. But there is no way we can do this. One way or another the process of globalisation, of breaking down borders will take place and become a fact of life" (Mahathir, 1997b) Despite this, Malaysia had not closed its doors to global progress and growth, as the benefits of international trade were embraced via the economic and financial liberalisation in the 1980s. The BNM, the Malaysian central bank authorities were generally more cautious on financial liberalisation, both domestically and internationally as compared to its neighbouring countries (Jomo, 2005, p. 3). Equally, the Mahathir administration had been quite sceptical of the globalisation agenda because of the close relationship between the West and globalisation (Akbarzadeh, 2008, p. 316).

Time after time, Malaysian policymakers have defied the conventional wisdom about the most fitting measures of dealing with the Crisis and its domestic economies, especially in a time pigeonholed by intensified global integration. Under Mahathir's leadership, the Malaysian government had initiated economic policies which safeguarded the social harmony of its citizens whilst lessening the pressure from foreign influences, and declined to strictly abide by the neoliberal doctrine of financial liberalisation. Stiglitz (2002, p. 122) states that "Malaysia was severely criticized during the Crisis by the international financial community. Though Mahathir's rhetoric and human rights policies often leave much to be desired, many of his economic policies were a success." Hence, in this regard, Malaysia has drawn special attention amongst countries afflicted by the economic disaster in Southeast Asia. Mahathir highlighted several major concerns on the states and markets relationship and about Malaysia's ability to pursue distinctive policy responses. After the riots in Indonesia[7], Mahathir had mentioned his concerns to Stiglitz[8] (2002, p. 120), that he knew "that all the gains in building a multi-ethnic society could be lost, had he let the IMF dictate its policies to him and his country and then riots had broken out." For him, preventing a severe recession was not just a matter of economics, it was a matter of the "survival of the nation."

[7] The riot in Indonesia was the result of food and fuel subsidies were drastically cut back for the poor, when the Indonesian government adopted IMF's draconian policy response in exchange for a USD23billion financial package.

[8] This was during a meeting attended by IMF's managing director Michel Camdessus, and G-22 finance ministers and central bank governors in Kuala Lumpur, Malaysia, in early December 1997.

2.1 East Asian Miracle

In 1993, the World Bank had produced a report titled "The East Asian Miracle: Economic growth and Public Policy" (East Asian Miracle report) which highlighted the achievements of eight high performing Asian economies (HPAEs) and the HPAEs were divided into three categories:

i) Japan;

ii) Four Northern Asia countries: Hong Kong, Republic of Korea, Singapore and Taiwan; and

iii) Three newly industrialising economies (NIEs): Indonesia, Malaysia & Thailand.

According to Wade (1996), the study was undertaken by the World Bank at the insistence of Shiratori, the Japanese Executive Director of the World Bank. For many years, the Japanese government had been frustrated with the neoclassical economic doctrine and free market orthodoxy that had come to dominate the World Bank's thinking and policy recommendations, especially with the revitalisation of neoliberal economic fundamentalism in the 1980s (Jomo, 2001c). The World Bank had assumed that a standard policy framework for all developing countries. Shiratori had highlighted that East Asia's fast development and structural adjustment was a significant departure from the World Bank's structural adjustment programmes in Latin America, Africa and other parts of the world. The Japanese government wanted the World Bank to study and learn from the East Asia experience as the eight HPAEs had grown at average rates of over 6% since 1965 up until early 1990s (World Bank, 1993; Wade, 1996; Jomo, 2001b) and it even offered to fund the East Asian Miracle report.

Eventually, the Japanese-funded East Asian Miracle report was undertaken and concluded that the three NIEs, namely Malaysia, Indonesia and Thailand had achieved rapid export-led growth via state intervention (Stiglitz, 2001; Keating, 2015). The World Bank had recommended that these NIEs were to be models for other developing countries with an obvious message that external liberalisation not only meant faster growth but also greater equity. However, Jomo et al. (1999) criticised the World Bank's claims on the NIEs being outstanding models for other developing countries, indicating to a variety of discrepancies to highlight the inadequacy of Southeast Asia's economic achievements. This was supported by Yoshihara's (1988) argument that NIEs were described as ersatz capitalism due to the weakened and inferior position of their states, their inability to establish further technological proficiencies and their inequitable handling of indigenous Chinese.

Table 2.1: Economic indicators of the crisis-affected HPAEs, 1970-1995

Economy	Per capita income (USD)	Average annual GDP growth (%)		Manufacturing/ GDP Share (%)			Agriculture/ GDP Share (%)		Service/ GDP Share (%)	
	1995	1970-1980	1985-1995	1970	1980	1995	1980	1995	1980	1995
South Korea	9700	10.1	7.7	21	29	27	15	7	45	50
Malaysia	3890	7.9	5.7	12	21	33	22	13	40	44
Thailand	2740	7.1	8.4	16	22	29	23	11	48	49
Indonesia	980	7.2	6.0	10	13	24	24	17	34	41

Source: World Bank (1997) from Tables 12, 13 and 15, adapted in Jomo (2001a).

Table 2.1 exhibits the crisis-affected countries, which consist of three NIEs and Korea, a Northern Asia HPAE, included for comparison purposes. All four countries have seen unprecedented growth and structural revolution in the last few decades–the highest growth rates in the world (Jomo, 2001a). During the period, average annual GDP growth rates surpassed 6% and manufacturing became the main contributor to growth and exports grew annually at double-digit rates between 1980 and 1992 and average per capita income increased greatly (Jomo, 2001a).

However, the Panic of 1997 had completely changed international opinions and sentiment towards the East Asia capability, from admiration into harsh condemnation (Jomo, 1998b; Wade, 1998a). This was highly evident with respect to the matter of business-state relationships, which had formerly been described as fundamental to the East Asian miracle. On the contrary, the usually closed business dealings have since been criticised as "crony capitalism" accountable as the root as well as the gravity of the Panic of 1997 (Wade, 1998a; Backman, 2001). Several analyses by Krugman (1998) and Jomo (1998c) have since described the Panic of 1997 as the reaction to global financial liberalisation coupled with the readily reversible foreign capital flows. These accounts have also highlighted the significance of the IMF in its role of policy instructions and conditionalities in worsening the economic situations (Jomo, 2001b).

The Malaysian government believed that the Panic of 1997 as being a "conspiracy of Western hedge funds, Western governments and the IMF to impoverish East Asia" by creating the conditions for the crisis (Athukorola, 2001, pp. 6346; Mahathir, 1998). It also viewed the Panic of 1997 as being the "result of the Treasury-Wall Street Complex theory, whereby the Federal Reserve Bank collaborated with Wall Street" by making cheap credit available for hedge funds to invest in East Asia to create a bubble which they could profit from by being the first one to 'sell and run' (Sivalingam, 2008, p. 2). This viewpoint had received some academic credibility from the works of Stiglitz (1998), Bhagwati (1998) and Wade and Veneroso (1998).

2.2 The Globalisation Experience in Southeast Asia

Balancing the benefits against cost, risk and the possible social hazards of globalisation is one of the key challenges to developing nations. Intensified competition that drives production shifts in a nation will bring to better resources allocation and better energy and productivity. However, the net benefits were not distributed equally because some regions or states develop much quicker than others. Globalisation has many merits, but it has been a bone of contention on its societal effect, particularly in the dealing with the costs and risks.

Liberalisation of economies to global trade had stimulated rapidly many nations' progress much more than they would have. When a country's economic expansion is pushed by its exports, international trade stimulates economic progress. Export led growth was the heart of the industrial strategy that enriched many Asian countries and resulted in providing millions of people increased better job opportunities. Many communities around the world now have better medical facilities which decrease mortality rate and enjoy better standards of living due to globalisation. The perspectives on globalisation depend on which end of the spectrum that it is viewed from. For example, the Western society may consider Levi's low-paying jobs as exploitation, but on the other end, being a paid factory worker is a much better choice than cultivating rice on the field for many communities (Stiglitz, 2002).

2.2.1. First Phase: Initial Liberalisation (1970 to mid-1980s)

The NIEs - Malaysia, Indonesia and Thailand were rich in natural resources and were agricultural based exporters until the 1970s. They had relied on a few essential commodities exports to secure foreign exchange. During the mid-1980s, these countries began to industrialise by import substitution and then gradually converting to exporting, generally goods that were labour intensive as unskilled labour were economically available, whilst continuing with import substitution to protect the domestic market. Import substitution was crucial to develop the industries that can source domestic consumer products, that gradually progressed into intermediate and capital goods. These countries had imposed tariffs on finished products as well as the gradual adoption of non-tariff barriers.

However, the barrier that created protective measures on domestic goods had resulted in the manufacturing process of goods to be inefficient and expensive. In addition, the manufacturing of import substitutes was clustered in urban areas and capital-intensive industries did not benefit the majority of the unskilled workforce. Concurrently, all three NIEs began promoting export-oriented goods because import substitute goods were restricted by a small local market. Furthermore, globalisation had compelled the developing nations to engage in foreign trade. The focus was initially on the export of manufactured goods, which required largely unskilled labour due to the significant competitive advantage.

Malaysia implemented a moderate import substitution policy much earlier than the other Southeast Asia countries, and most of the factories were located on the edge of a major urban area in Peninsular Malaysia with proximity to the final market. By 1970, Malaysia had adopted the industrialisation of export-oriented goods in tandem with its import substitution strategy. Malaysia had focused on industries such as electronics (semi-conductors) and textiles because of the competitive advantage of cheap labour. The government's primary objective was to attract foreign investors via granting investment incentives, tax-breaks and subsidising export credits. In addition, industrial estates and free trade zones were created in to encourage foreign companies to set-up manufacturing plants in export processing zones such as Penang, Selangor and Melaka (Leinbach, 1982, p. 464).

2.2.2. Second Phase: Rapid Globalisation (1980s onwards)

The Policy Shift

The fundamental industrialisation swing in the mid-1980s to the export-oriented goods in the NIEs occurred when there was a drastic price drop of their commodity exports. Global recession, preceded by the drop in oil prices in 1986, had pushed the NIEs to diversify exports and shift to export-oriented industrialisation. Compared to the Northeast Asian nations such as Korea and Taiwan, the NIEs were able to prolong their import substitution policies further because they could make profit in terms of currency exchange from exporting of commodities, though dependence on a limited range of these commodities made them susceptible to fluctuations in price and demand (Pangestu, 2001). For Korea and Taiwan, the export-oriented goods was reasonable for economic advancement as they are not rich in natural resources (Masuyama, Vandenbrink and Yue, 1997).

The policymakers and business communities in Thailand realised that the political transformations in Indochina[9] were an opportunity to establish Thailand as a hub for the region, specifically in finance. The bigger international investment flows of the 1990s coupled with the unrelenting high funding cost from an inefficient local banking segment rendered it attractive to draw funds from international capital markets (Blendick, 2007).

[9] The three countries of Cambodia, Laos, and Vietnam represent Indochina, located in Southeast Asia to the south of China and to the east of Thailand.

In 1985, Malaysia also saw a contraction of its economy by 1% due to an alarming decline of foreign direct investment in addition to a banking crisis (Khan, 2011).

The role of government has been extremely important in providing social infrastructure and services in East Asia. Compared to the Northeast Asian economies, the NIE's industrialisation model, also emphasised education. The World Bank seemed to recognise this, but nonetheless it proposed a more moderate role for government in the provision of social framework. For example, the World Bank advocates comprehensive and free primary education, but did not endorse the subsidisation of education beyond the primary level (World Bank, 1993). This would have had very major repercussions in terms of human resource improvement if it was compared to East Asia's actual experience. The significance of government support for tertiary education was critical in its human resource development. In 1993, for instance, Korea had approximately 48% of its youth attending universities, with Thailand close to 20%, Indonesia at 10% and Malaysia at 7% (Pasuk Phongpaichit and Baker, 2000; Jomo, 2001a).

During the 1950-60s, the growth of global trade led to great prospects for export-led expansion and more industrialisation opportunities were created by the transnationalisation in manufacturing activities. The establishment of General Agreement on Tariffs and Trade (GATT) had led to a global environment favourable for trade development. Although world economic expansion has scaled down since the 1970s, global environments have remained encouraging to industrialisation. At the same time, the restoration of trade barriers and the improvement of new global economic governance had led to less promising circumstances (Jomo, 2001c). The formation of the World Trade Organisation (WTO) has increased transnational corporate control and enforced further costs on new industrial development efforts, particularly under the patronages of domestic investment. However, prospects still reside within the developing global economic setting. After the mid-1980s recessions in the Southeast Asia, economic revivals were primarily maintained by better prices for main commodities, currencies marked depreciation and foreign capital, specifically in export-oriented manufacturing.

Foreign Direct Investment (FDI)

The East Asian Miracle report did not highlight the importance, type, and repercussions of FDI in the HPAEs, even though the World Bank had been worried that countries continued to be exposed to foreign investment. Controls on FDI have permitted globally competitive local manufacturing companies to develop in certain East Asian countries, normally with state protection. Such control has also improved the profits and cut down the losses to the domestic economy from the manifestation of FDI. As illustrated in Table 2.2, amongst the HPAEs, the annual averages of FDI as a percentage of gross domestic capital formation is wide ranging, as only Singapore and Malaysia have depended considerably on FDI. The higher adoption of FDI would likely be an interim feature of a relatively initial development phase, when aggregate internal capital, technological readiness, and access to external market are limited. For instance, Korea had depended on FDI in the early 1970s and gradually reduced its reliance in the 1980s and 1990s (Chang, 1996).

Table 2.2: FDI as % of Gross Domestic Capital Formation in HPAEs, 1991-97

Country	1991	1992	1993	1994	1995	1996	1997
Indonesia	3.3	3.6	4.3	3.8	6.7	8.8	6.9
Korea, Rep. of	1.0	0.6	0.5	0.6	1.1	1.3	1.8
Malaysia	22.8	26.0	20.3	14.9	11.0	n.a.	n.a.
Philippines	6.0	2.1	9.6	10.5	9.0	7.8	6.2
Singapore	33.7	12.4	23.0	35.0	26.0	21.7	n.a.
Thailand	4.9	4.8	3.7	2.4	3.0	3.2	7.2

n.a. Not available.

Source: Jomo (2001c Table 12.1)

The significance of FDI at a specific point in time may also be principally dependent on the investment outlook of foreign investors. East Asians' industrial relocation within the region were consistent with the FDI product-cycle as described by the "flying geese" theory[10]. However, the design and rate of industrial reformation in East Asia were not

[10] Akamatsu's "flying geese" model was the development orthodoxy among Japanese economists and intellectuals in the early and mid-1990s (Akamatsu 1962). The basic theory is a "follower" country first imports a product from a more "advanced" country, then it produces the good for itself, and finally, it exports the product to other countries. A follower country ascends the technology ladder sequentially, learning to produce goods of increasing value, sophistication, and complexity. In trying to do so, it may protect infant industries and encourage new exports.

merely market driven, but influenced by home-host country industrial policies that have urged industries to reposition out of the country (Jomo, 2001c).

Financial liberalisation in Southeast Asia

The financial liberalisation of the Asian economies occurred throughout the 1990s, urged by domestic business leaders as well as supported by the IMF and World Bank. The liberalisation of the financial systems included their external capital account, had allowed domestic agents to obtain finance on external markets and provided foreign agents entry to the national financial market. Consequently, residents have access to foreign bank accounts; credit facilities in foreign currencies were made available domestically; resident companies were able to borrow abroad; share ownership of national listed companies were accessible to foreigners; better accessibility of domestic banking market to foreign banks and off-shore financial institutions had access to financing abroad and provided credit domestically (Islam, 1998). Hence with liberalisation, governments were able to relinquish their function to organise foreign private borrowing. Financial liberalisation and easing restrictions on capital account is risky when the domestic banks have insufficient global financial markets experience and when private companies also borrow overseas (Wolf, 1998a). In Asia, rapid external financial liberalisation with non-regulated banks and fixed exchange rates undermined the earlier structure of industrial and banking collaboration and leave delicate debt structures unprotected against unbuffered shocks (Wade, 1998a).

In the Southeast Asia region, financial liberalisation had considerable ramifications, owing to the external influence of mainly internationally competitive activities in the region. Therefore, there were several manifestations of macroeconomic matters which had turned up by the mid-1990s from the swift expansion of the preceding decade. Firstly, the substantial dependence on FDI and external loans to fund the savings-investment gap, when both FDI and foreign loans led to investment revenue flowing out of the country. In the 1990s, the current account deficit was progressively funded by short-term capital inflows, as in 1993 and 1995, with subsequent dire consequences with the reversal of the inflows (Jomo, 2001a). Measures of confidence renewal were taken to promote the inflows of such short-term capital inflows then, but it will not tackle the underlying issue in the medium to long term. Although it was not in the mainstream in the 1990s, external portfolio investments gradually swayed the region's stock markets. The regional existence of these foreign banks was susceptible to herd mentality, caused by insufficient information aggravated by restricted transparency. The naturally biased character of fund managers' remuneration and incentives, combined with the short-termism of their investing perspectives, had thus caused most intense regional contagion.

Secondly, in the 1990s there was a surge of debt from the private sector notably from abroad, as foreign loan pushers were eager to gain higher profits from the HPAEs. Commercial banks' external loans also rose rapidly as the ratio of loans to GNP grew faster during the phase. The current account deteriorated due to the over-investment of investible non-tradeable assets, specially from overseas. Only a minor percentage of bank loans were extended to manufacturing projects, and with even a smaller proportion of foreign loans because most of the debt consisted of collateralised assets such as real properties and shares. Thus, considerable inflow of external savings gave to the hike in asset price, mainly involving real estate and share prices. Such investments did not build up the production of trade products, but they did the opposite by worsening the current account deficit, rather than mitigate it. Consequently, they exacerbated the issue of "currency mismatch", with US dollars loans spent in projects not spawning foreign exchange, as a significant share of these foreign loans were short term but used to fund medium to long-term projects. It was reported by the Bank for International Settlements (BIS) in January 1998 that more than half of the foreign loans by commercial banks were short-term with 56% in Malaysia, 66% in Thailand, 59% in Indonesia and 68% in Korea (Chang and Velasco, 1998, p. 30).

Trade Liberalisation and Foreign Investment Policy

The aim of trade policies was predominantly to eliminate protection in phases, first by adjusting the non-tariff barriers to tariff equivalents and then gradually streamlining and diminishing them. In addition, exports were reinforced by rationalising customs measures and eliminating administrative bottlenecks, as well as removing additional costs on imported inputs for affected exporters. The gradual eradication of trade barriers allowed the export-oriented industries to continue together with the import substitution industries.

Malaysia then launched a vigorous second phase of import substitution by promoting heavy industries such as automobiles, steel, and cement industries. Protection was yet comparatively strong, but export-oriented industries was strengthened by duty-free import inputs for exporters and establishment of export-processing zones.

The NIEs fought for foreign investment as it was considered to be critical for export market access and to gain the laissez-faire for export-oriented industries. The deregulation of foreign investment with the lessening of controls as well as increasing incentives for foreign investments were to encourage the development of export-oriented industries. Deregulation also included permitting nearly complete foreign control in export-oriented investments. Malaysia also initiated financial and new incentives for R&D activities. In Thailand, the government launched investment opportunities were linked to export-oriented activities in the provinces (Athukorala, 1998).

Capital and Financial Sector

The NIEs undertook the liberalisation of their capital account and financial sector and in somewhat distinctive approaches. Indonesia's capital account was opened since 1969, with few restrictions on its reporting requirements, and in the late 1980s, it was also the country that went furthest in the liberalisation of its financial sector. While Thailand's prolonged restrictions on the banking sector led to the establishments of non-banking financial businesses, which grew to be the central channel of capital inflows (Athukorala, 2000). In Thailand and Indonesia, these inflows were funnelled through defective systems and stimulated growth, but it was growth in non-producing products, essentially real property and infrastructure (Abu Bakar, 2000). Whilst Malaysia's issue was expansion of internal credit.

Growth and structural change

The rapid globalisation among the HPAEs led to high growth of GDP and exports, and made these countries become an integral part of the global economy. It also led significant structural transformations in GDPs, for instance, in Indonesia, the proportion of the manufacturing activities surpassed agriculture for the first time in 1990 (Pangestu, 2001).

For the NIEs and Korea, exports peaked in the first quarter of 1995. However, the subsequent collapse was severe and unprecedented. According to a later World Bank report (1998, pp. 20–23), growth in export for the HPAEs dropped from 21% in 1995 to merely 4% in 1996. Thailand's exports declined by 1%, while Malaysia's exports grew just over 6% (World Bank, 1997). Only Indonesia had a modest growth of 9% due to the appreciation in oil price. The report further analyses that two-thirds of the economic slowdown were caused by cyclical factors such as significant decline in global trade, depreciation of the Japanese yen, and a large decline in primary export prices. Apart from experiencing fast growth, East Asian exports were also shifting significantly from agricultural based and unskilled labour-intensive products towards skilled and capital-intensive products and services (World Bank, 1998).

In the mid-1980s, the rapid integration of East Asia with the global trade was stimulated by the HPAE's drive to push for their export-oriented industries by establishing more locations for manufacturing and export. This factor is also reinforced with the external investment drive of firms in Japan and Northern Asian countries like Korea and Taiwan, caused by rising costs of production due to currency appreciation, rising wages and labour shortages. These investments were mainly meant for export but worked out to support the domestic market as well. Other factors such as segregation of process into various components and stages of production and the increasing competition from cost effective producers such as China had spurred the swing from unskilled labour-intensive exports into specialised high-tech exports (World Bank, 1993). Export structures became more specialised and were more inter-reliant, consequently exposing these economies to higher risks of market recession and surplus capacity as well as contagion (Wade, 1999).

The improved investment environment and liberalisation of the financial sector drew unprecedented foreign investment into NIEs. They grew higher than ten-fold in Indonesia in the 1990s, from approximately USD1 billion in 1989 to nearly USD11.5 billion in 1995 (Pangestu, 2001). Thailand became the primary beneficiary of the fresh FDI, which rose 15-fold between 1985 to 1990, while other capital flows increased substantially with a portfolio capital hike in 1993 and surpassed the FDI over the following 4 years. Banks and other loans started to grow in 1989 and developed into the largest component in the capital account (World Bank, 1993).

The substantial inflows of foreign capital had led to infrastructure development stimuli, the comparative price inflation, the hike in asset value and liquidity excess in the financial structure. There was also a preference towards non-tradable products such as construction, property, and infrastructure. In Malaysia, capital inflows were funnelled via the stock market, and financial institution funded the increasing current account deficit created by the mounting production of non-tradable commodities utilising imported goods (Jomo and Lee, 1999).

2.3 Malaysia's Globalisation Experience

Malaysia officially began its industrialisation initiative after its independence in 1957 and advanced stage by stage through the path of economic advancement to achieve its goal of turning into a 'fully developed' country by 2020. However, globalisation of its economy essentially began from 1970 and the momentum increased gradually up until 2007. Malaysia approached its economic globalisation very cautiously and selectively and only dealing within significant markets in Europe and North America.

Globalisation is unquestionably a complicated, multidimensional universal experience. Mahathir had clearly recognised that it is not only crucial to uncover its integral components, but it is imperative to identify that certain ‘flows’ outlined above are probably much more beneficial and favourable than others. This insight explained his violent condemnation on another crucial component of globalisation: the financial markets’ growing influence on global economy. The integration of financial markets is perhaps the utmost far-reaching accomplishment in globalisation. The efficiency and agility with the flow of capital across state borders make them symbolic of the new global order. The narrative of the rise and pervasiveness financial markets influence, technological advancement and political vigour played essential roles. The key point to emphasise here is the utter size of financial transactions in comparison to domestic economies, particularly countries like Malaysia. The world's financial markets have touched approximately USD2 trillion of capital flow per day (Lietaer, 1997) compared to Malaysia's annual GDP of USD98 billion in 1997 (World Bank, 2000). Compounding the risk given by such immense capital movements, with up to 97% of capital flows may be speculative, exceedingly liquid and very distinctive from the long-term FDI linked with the development and shift of real productive activities (Beeson, 2000). Even though the causes for the Panic of 1997 were complicated, the majority of Asian countries would concur that financial markets played a significant part that was intensified by their sheer scale. It is worth indicating that Malaysia's execution of currency controls were given noteworthy support from esteemed conventional economists like Paul Krugman (Krugman, 1997).

Traditionally, the financial markets especially within the NIEs were tightly controlled, thus protecting them from foreign intervention. The policymakers of the NIES consider the opening up of the domestic financial markets to be a risky undertaking. Even though this may provide domestic business with the access to bigger and probably cheaper funding, it may come at the price of weakened control over the financial system, and hence greater vulnerability to the sorts of disruptive financial flows that led to the Panic of 1997. Despite the attempts of policymakers in Southeast Asia, the liberalisation of the financial market has often occurred, for instance, in Japan, the initial home of the typical state-led development, as an effect of a complex combination of internal and foreign forces. External pressures particularly coming from the U. S, combined with the changing priorities of national corporations and banks, resulted in further liberalisation despite opposition from the state government.

Asian leaders such as Mahathir had considered that the economic liberalisation, specifically in the financial segment, to be fundamentally risky to the HPAEs' economic structure. He had depicted it as partly an attack by "the West" created to hold back Asia's economic progress and ensure their subordinate status. Take into account the pace at which Asia was advancing, the region turned out to be on its path for global economic dominance. The HPAEs were seen as a threat to Western hegemonic powers, whether they would ultimately turn to dominate the world is immaterial. But obviously their concerns have allowed the chance to push for opening up of their economies and allow control by more influential communities.

The evolution of financial markets is not known solely as part of a broad process of secular change motivated by scientific modernisation and economic reorganisation, but as a process which distinct internal welfare is being followed. Mahathir understands such evolutions as a progression that not only emanated from the West, but which heavily supports particular interests there. Furthermore, he believed that the rising influence of powerful inter-governmental institutions like the World Bank or the IMF as purely a diplomatic feature of globalisation, and that any international intervention would witness the weakening of national sovereignty. In summary, the NIEs especially Malaysia were witnessing a hegemonic form of neo-colonial political control created to reinforce the interest of the West. Undoubtedly, there are few drawbacks with such broad-brush interpretations of either "Asia" or "the West." However, in spite of the ambiguity, it is essential to recognise that not entirely do Mahathir's perspectives often find a responsive Malaysian audience, but they also unearth matters with much wider significance. Before examining the allegations and the unique reaction they have spawned in Malaysia, the underlying foundation of Mahathir's perspective and his policies must be deliberated in further detail.

2.4 The Impact of Neoliberalism

Methodically, Malaysia was tightly governed but sanctioned neoliberal measures in accordance to regions, developments, and communities. These precursory policies akin to neoliberalism were not described as neoliberal policies because they were instituted at an earlier time or justified as merely ‘pragmatic’ policies. The government in Malaysia was recognized for being exceedingly sympathetic in favour of the Malay business community and this was demonstrated via the implementation of the NEP. But the government also differentially safeguarded and controlled specific segments of the economy, while closely supervising labour.

The Malaysian government had encouraged the EOI segment, primarily dominated by multi-national companies (MNCs) by giving financial incentives and other form of support but had allowed the MNC to be free of any red tapes. However, the government did not show any support for the Chinese dominated small medium enterprise (SME) segments. It was only much later in the 1980s during Mahathir's government that the SMEs played essential role to Malaysia's heavy industries development. For instance, the government had initiated under its national car project (Proton car), a vendor development program.

During Malaysia's recession 1985/86, the initiatives under the NEP were put on hold to attract more FDIs and domestic capital. Mahathir via the MoF had initiated privatisation, cut budget allocations for public organisations, established tighter budgets, and early repayment of external debts, policies that had similar characteristics of neoliberalism. After the recession, Malaysia's development continued rapidly, and the government had liberalised and privatised public services that had formerly stayed within the government control. Public service such as energy production, communications, utility provider, healthcare services, and higher education were privatised, and these were typical neoliberal course of actions.

Up until the Panic of 1997, Mahathir's economic nationalism seemed to be consistent with the framework of neoliberalism. Indeed, his neoliberal shift could be rationalised in nationalist terms. The neoliberal practices reconciled national and certain group welfares, such as the transfer of national assets to Malay capitalists through privatisation and the deregulation restored the government's relationship with local Chinese entrepreneurs hindered by bureaucratic boundaries.

2.5 The Malay Dilemma

Malaysia's unique multi-ethnic demographic structure had historically defined and constrained its social and economic policy as Malaysia's demographic consists of a contentious mix of native Malays, a significant Chinese group, and an Indian minority. When Malaysia achieved its sovereignty from Britain in 1957, the proportion of the

Malay and other ethnic communities were approximately equalised. By 1990, the proportion of Malay population was nearing 60%, the Chinese had dropped to about 30%, while the Indian to roughly 10%. Although ethnologically based economic sectors and politics are less relevant than they previously were, it is crucial to recall that Mahathir's reputation originally grew by his strong opinions expressed in his book, the "Malay Dilemma" (Mahathir, 2010)[11] verbalising an ethnic reaction to the current social condition and that the "new ethnic Malay capitalist class is predominantly a formation of the state".

Subsequently, the Malaysian administration had pursued defensive economic policies with complicated amalgamation of social and economic objectives, intervened by Malaysia's ethnically segregated political parties. One of the primary objectives of the NEP was to increase the share capital of Malay in businesses by 1990 via the setting-up of government trust agencies to acquire shares in favour of the Malay community, with the implied aim of reallocating them in the future. Accordingly, public-owned enterprises increased considerably during the 70s and early 80s, providing the base for the combination of state and corporation gains which is now a trait of the political economy in Malaysia. The pursuit to safeguard Malay interests for the benefit of social harmony were much linked to the genesis and the propagation 'crony capitalism', which has brought much widespread critique of Southeast Asia systems of capitalism and industry procedures in the aftermath of the Panic of 1997.

In distinguishing Malaysia's globalisation experience, it is necessary to establish some comparative arguments and emphasise the distinctive political and social conditions through which the globalisation have been filtered. Firstly, Malay capitalists are effectively a conception of the state, traditional differences between the political and commercial affairs are totally irrelevant. The dominance of Malaysia's politico-ethnic administration to preserve the ethnic balance via the establishment of an indigenous

[11] In *The Malay Dilemma*, former prime minister Mahathir Mohamad examines and analyses the make-up of the Malays and the problem of racial harmony in Malaysia. First published in 1970, the book seeks to explain the causes for the 13 May 1969 riots in Kuala Lumpur. It was first published in Singapore in 1970 and initially banned in Malaysia.

capitalist group, had brought Malaysia's economic landscape to a synthesis of political and commercial interests. The ruling party United Malay National Organisation (UMNO)[12], the primary vehicle of Malay political authority is itself deeply engaged in commercial transactions, as UMNO had established 'mega conglomerate' of businesses and commercial investments which cover most areas of the economy. Accordingly, key people in both the government and UMNO have attained substantial financial enrichment principally as a direct result of their political affiliations. For instance, Daim Zainuddin the director of the NEAC has been a leading beneficiary of Malaysia's affirmative discrimination concerning the Malays. Gomez and Jomo (1999) have described how Daim's political relations have granted him to grow widespread business profits and considerable personal wealth. Undeniably, they argue that the "ethnic cudgel of Malay progression has facilitated influential Malay officials and capitalists with close relationships to UMNO" to systematically accumulate vast personal gain (Gomez and Jomo, 1999).

While the abuse of political relationships for personal wealth is scarcely uncommon to Malaysia, there are features of the Malaysian example that are peculiar as well as conflicting, as compared to the other HPAEs. Malaysia does not simply fit into the usual reverent of miraculous Asian tigers descriptions, in which a comparatively autonomous bureaucracy is known to have influenced the course of economic development. In addition to the fact that the ruling Malaysian government was a powerful actor compared to HPAEs like Japan, Mahathir also showed little affinity for the administrative procedures and has methodically waned its independence and power. Mahathir has revealed to be highly contradictory, yet relevant, opinions of both the market forces and bureaucracy. The Prime Minister was eager to capitalise on the potential of market forces to revamp inefficient bureaucratic procedures and to an extent certain Malay value. But his administration also promoted a structure that would transform Malay values and facilitate the Malays into becoming more credible entrepreneurs, be less reliant financial support or links with Chinese entrepreneurs. This positive discrimination towards the

[12] During Mahathir years, the Malays was a majority ethnic group and was divided by different ideology towards Islam: 1) the moderate UMNO and 2) the extreme opposition party, PAS.

Malays in achieving the goals of the NEP had put pressure on Mahathir and were severely criticised against at the international front (Chin, 2000).

In essence, Mahathir pursued on capitalising on transforming the Malay economy without foregoing any authority or supervision. This paradoxical position is evident in Malaysia's political landscape as plenty of the UMNO's request has been achieved from what Crouch (1996, p. 37) calls its "patronage-dispensing function". The preservation of UMNO's leading political stand is yet conditional on its capability to handle and administer economic resources, to some degree which could be jeopardised by the kind of extensive transformations that have been recommended, and to some extent carried out. And still Malaysia validated that it is feasible to respond to supposedly universal forces in fairly idiosyncratic approaches. For instance, the privatisation methods which have developed into such a pervasive part of public policy turned into an instrument for the amalgamation of political and financial strength for a certain group of predominantly privileged Malay elite. As Searle (1994, p. 108) notes, whatever the economic arguments for privatisation, the raison d'tre for the program in Malaysia has been primarily political. Alternatively, when mediated throughout the filter of Malaysia's highly distinctive ethnic and political arrangements, even privatisation, one of the characteristics of globalisation was acknowledged to be profoundly distinct from the usual conventional description.

But it is noteworthy to acknowledge that privatisation strategies were successfully realised within the bounds of domestic economic spaces, no matter how hypothetically ambiguous and reasonably porous such a notion may be. Apart from privatisation, alternative processes more immediately linked with globalisation have brought even bigger challenges for other world leaders. However, for smaller countries like Malaysia, the distinct character of the Malay leadership's response rendered it remarkable and shed light on the boundaries of domestic sovereignty in the present-day global political economy.

A couple of additional reasons also deserve emphasis. Firstly, the "Malaysian economy is highly liberalised by global standards", and had become progressively more so. "Imports plus exports of goods and non-factor services represented 211% of GDP in

1998, an increase from 105% as reported in 1988” (BNM, 1999c). This means that Malaysian policymakers are highly reliant on controlling access to the broader global economy. Moreover, not simply has Malaysia's coverage to the global market system considerably increased, but the kinds of products that Malaysia trades with the world have also improved. Next, there has been a profound secular shift in the architecture of Malaysia's economy: manufacturing had flourished to more than 33% of GDP by the mid 1990s, up from less than 7% at the time of independence in 1957 (Jomo *et al.*, 1999, p. 89). It has been this growth of the manufacturing sector, coupled with the corresponding decrease in the agriculture sector, that has strengthened the GDP growth rates and the increasing standards of living that have been linked with HPAEs industrialisation. Essentially, it has been strictly the plan of "substantive performance and material benefits that has underpinned the validity of, and prominent backing for, recent Malaysian governments” (Case, 2010). In an atmosphere in which states appear powerless to give on such a guarantee and appear vulnerable to shield society from foreign provocation, the security of governmental rule is unavoidably emasculated.

The possibility for commercial issues to spread out into the “political sphere was apparently manifested in the overthrow of Mahathir’s deputy, Anwar Ibrahim” who was also the Finance Minister then (Case, 1999). There is no purpose here to analyse that matter in detail other than to remark that the Panic of 1997 aggravated existing leadership pressures, and that foreign agencies such as the IMF sought to persuade “Malaysian domestic politics in favour of Anwar, who was regarded to be an advocate of the market-friendly policies the IMF” was seeking to restore throughout the crisis-affected region (Calomiris, 1998). This national and foreign political tussle makes any objective review of Malaysia's responses to the situation exceptionally challenging. More fundamentally, in the Malaysian case the experience helps to prompt us just how closely related politics and economics were. Nevertheless, a review of Malaysia's response to the Panic of 1997 in specific and to globalisation in general, are of significance as they highlight various concerns of broader importance.

2.6 Mahathir and Middle Power

Malaysia only truly entered the international scene in July 1981 when Mahathir was appointed to office as Malaysia's fourth Prime Minister. The introduction of this strong charismatic leader who aspired to witness this Southeast Asia country accomplish greater sovereignty and reach its rightful position on the world arena, corresponded with the evolution of a global and national setting favourable to a country undertaking initiatives on the international arena (Hilley, 2001).

As the head of state, Mahathir immediately saw the political prospect of profit from the Division of the North–South preferably than the Eastern-Western divide, so he pushed for the establishment of a South-South Commission in 1986 (Dhillon, 2009). When the Cold War ended, it allowed middle dominions to eventually have a voice without considering choosing sides between the two superpowers. In the pursuit for a contemporary position in the era after the Cold War, Mahathir also sought to revitalise the Non-Aligned Movement (NAM) as an avenue to fault a world order regarded as unjust. In 1992, he blamed the North accountable for international environmental problems at the Earth Summit in Rio. His candid viewpoints had caught international attention and the Far Eastern Economic Review had regarded Mahathir as the 'new voice of the Third World' (Saravanamuttu, 2010, p. 116).

Malaysia, being economically independent, was no longer considered the state of the former British colony. Any development support fund previously received is replaced by FDIs. However, regardless of his requests for a new global order, Mahathir realised that Malaysia had limited influence over the regional development or politics. He was aware that Malaysia could not exercise more control than the de facto dominance of Indonesia within ASEAN[13], owing to the scope of its large province and vast population. This

[13] The Association of Southeast Asian Nations, or ASEAN, "was established on 8 August 1967 in Bangkok, Thailand, with the signing of the ASEAN Declaration (Bangkok Declaration) by the Founding Fathers of ASEAN, namely Indonesia, Malaysia, Philippines, Singapore and Thailand. Brunei Darussalam then joined on 7 January 1984, Viet Nam on 28 July 1995, Lao PDR and Myanmar on 23 July 1997, and Cambodia on 30 April 1999, making up what is today the ten Member States of ASEAN" (https://asean.org/asean/about-asean/)

motivated him to favour either a more focused or dedicated global organisation in promoting the country's international evolution. The Organisation of the Islamic Cooperation (OIC) presented an alternative venue for Mahathir's objectives where Malaysia could present as an example of an industrialised Muslim nation.

Nonetheless, from the 1980s in Malaysia's domestic political landscape, Mahathir faced heightened opposition from Parti Islam Se-Malaysia (PAS or the Malaysia Islamic Party). PAS had jumped into the opposition coalition after the collapse of its short-lived participation of the governing coalition between 1974 until 1978 (Yasin, 1994). The reinforcement of the strategic affiliations with the Islamic world was also intended to secure the Muslim Malay constituency. Similarly, additional support was gained via his outspoken solidarity for the Palestinian cause, an exemplary international affair for the mainstream Muslim Malays. On the other hand, this constraint associated to awareness of the Malay constituency ran in correspondence to the increasing resentment of ethnic minorities. Mahathir's Look East Policy, along with the significance placed on Malaysia's heterogenous identity with the slogan 'Malaysia, Truly Asia', granted its dual purpose while also leading to domestic economic progress by branching out Malaysia's economic alliances (Muhamad, 2008).

Mahathir's administrative era was manifested by fluctuations between controversial outbursts and political pragmatism. At the pinnacle of his anti-American remonstrations, Mahathir still continued the strategic collaboration with the USA and commercial associations with the West. Though Malaysia remained as a member of the Commonwealth, Mahathir launched the 'Buy British Last' drive, encouraging Malaysian to buy Malaysian products and boycotting products from the UK. Mahathir's pragmatic characteristic despite his vehement stance against the West enabled Malaysia to retain an acceptable level of global integration. Mahathir acknowledged that Malaysia's progress depends on its successful assimilation into the global market and consequently, Malaysia joined the WTO in 1995. However, Mahathir's provocative statements, his anti-semantic declarations, eventually tarnished Malaysia's diplomatic relationships to the degree of provoking consequences on its socio-economic development. While Malaysia's status within NAM and OIC improved, Mahathir's image worsened gradually in the Western states.

On the international front, pressure multiplied with its closest neighbour and former federation member, Singapore. For the first time they retorted on the diplomatic facade in 1986 when the Malaysian government deemed the visit of Israeli President Herzog to Singapore as an insult to its anti-Israeli stance, while the Island republic saw it as an excuse to affirm its sovereignty from its neighbour. The pressure concluded with the termination of military collaboration after the revelation of an espionage scheme in 1989 (Acharya, 2007, p. 23). Nonetheless, confrontational situations have resurface from time to time around conflicts over specific issues such as the water supply which Malaysia contractually sells at an absurdly cut-price rate to Singapore, territorial disputes about jurisdiction over the atolls in the Straits of Johor, or the position of the Malaysian-Singaporean boundaries (Smith, 2004).

Despite these many arguments, several bases of Malaysia's diplomatic savoir faire were established or strengthened during the Mahathir administration, for instance, the broadening of the country's global collaborations, South–South cooperation and solid relationships with other Asian countries and the Islamic nations (Masuyama, Vandenbrink and Yue, 1997). Mahathir's vehement ambition for autonomy, signified by his defiance to accede to IMF's restrictive offered during the Panic of 1997, positioned Malaysia on the international chart and granted it the recognition of being a middle power.

2.7 Debating the IMF response

There were voluminous academic discourses on the IMF response during the Panic of 1997 but the works of Wade and Jomo are most relevant to this thesis to provide a good understanding of the Panic of 1997 from scholars of the "West and East." Being a Malaysian and an economist at the UN, Jomo had the advantage of domestic knowledge of the political and economic issues in Malaysia and its neighbours. However, Jomo is more critical than Wade in his criticism of Malaysia's policy responses, possibly from the dissatisfaction in the establishment of certain pragmatic policies that he feels had benefited the ruling elite party. According to their assessment, both scholars criticise IMF's diagnosis or rather misdiagnosis of the Asian situation and agreed to a certain extent made the situation worse than it should be, turning a currency crisis to a real economic crisis. Rather than strengthening its role in the Asian region, IMF had lost its credibility and the Panic of 1997 became a crisis of IMF legitimacy.

Wade (1998a) had candidly labelled 'Miracle Asia' to 'Cronyism Asia' as a gestalt shift in the world view of Asia, and more importantly the minds of capital owners. The gestalt shift was not just detrimental to Asia but set off a cycle of adverse events in other countries. This was due to commodity prices dropping to their lowest level, making it hard to maintain economic growth and promote public spending. Commodity producers from the emerging markets especially the Asian producers are experiencing downward pressures on their currency against the US dollar. Wade discusses the dichotomy of real and financial causes of the Asian financial turmoil and outlines the recovery strategy from the Panic of 1997. It employs the interpretative account of the different world views based on the rationality and non-rationality of the markets. Wade further outlines the scale of the Crisis and likened it to the Great Depression of 1930s.

Wade (1998a) suggests that the Panic of 1997 was caused by a sudden withdrawal of funds by investors, evident by the swing within one year of USD105 billion, with substantial outflow in the last quarter of 1997. The outflow based on a percentage to the combined GDP was even worse than Latin America's experience in the1980s. However, in contrast to Latin America, the large majority of the Asian household are net savers i.e. high domestic saving allowed the investment to be financed domestically. He further indicates that the IMF and the World Bank had encouraged the Asian governments to liberalise their financial sectors and opening of the capital account. Wade (1998a) points out that it was dangerous as the local banks have limited international experience and high debt-equity ratio corporate sectors.

Prior to the Crisis, capital inflow grew extraordinarily into Asia, driven by both the need to accommodate access investment over savings and the opportunity for foreign investors to get higher returns as well as the image of 'miracle' Asia. Excessive capital inflows combined with cheap foreign debts had resulted in the appreciation of the domestic assets. Hence, investment became excessive and companies began to invest in non-tradable speculative ventures such as property and land. Consequently, productivity and profits began to suffer. There was a massive accumulation of currency mismatch as borrowers receive returns in local currency and paid debts in foreign currency.

Mahathir had suggested that it would make more sense for the governments of the affected countries to apply their own economic policies without the interference of the extravagant country analyst and fund managers from Wall Street or the City. It is in the governments' interest to maximise returns on labour, technical progress and provide public goods that contribute to development rather than just maximising returns on capital. Jomo (1998) highlights that IMF agreed that the attack from currency speculators played a role in the downfall of the Thai baht but denies this for the collapse of other currencies. However, Jomo debated that currency speculation in isolation may have not brought down the other currencies, but the contagion effect unquestionably did. Foreign portfolio investors panicked and made anxious decisions to withdraw investments, which quickly escalated into massive capital flight (Jomo, 2006).

Wade and Veneroso (1998) provide an overview of the capital control approach that was adopted by the Malaysian government. This article analyses the support for capital control approach that was undertaken by the countries affected by the Crisis, in particular in the emerging markets. Wade (1998b) initially highlights the detrimental impact of the Panic of 1997, which eventually affected the rest of the world, one way or another. The Crisis had widened the gap in social deficit as spending on social welfare were cut in emerging countries, withdrawal of funds from Latin America, and the collapse of commodities prices.

The IMF's monopoly of the situation in the Panic of 1997 and the poor coordination of the World Bank and Asian Development Bank was highly criticised. This argument was further backed by the unsuccessful bid of Japan's USD100 billion Asia Monetary Fund, shot down by the US Treasury, which did not want any competitor to the IMF outside its jurisdiction. IMF's two-prong strategy was to promote the idea that the Crisis represent punishment to Asia for the government's mismanagement and to mobilise its 'policy reforms' to the affected government in exchange for funds (Wade, 1998a). It supported the argument that IMF's strategy was criticised from across the political spectrum as it did not work, when IMF had misdiagnosed the situation and had lost credibility in the region. Wade (1998c) further demonstrates that China escaped the direct impact of the Crisis because its currency was non convertible, hence stopping the inflows and outflows of hot money but without discouraging FDI. This analysis is important to this thesis as it highlights the reasons for Malaysia's enforcement on currency control based on China's model. Western financiers criticised Malaysia to the point of stating that Malaysia is uninvestable, despite Malaysia having the highest saving rates in world. Wade (1998b) concludes that capital controls are needed to make the economies less vulnerable to the vagaries of the portfolio managers and to restore growth. A new political landscape is emerging as East Asia nations will not simply accept further urge to liberalise capital. Wade (1998b) emphasises that the East Asians have more savings to be used productively and not depend on the capital injection from Wall Street.

Table 2.3: Percentage Change in GDP in East Asia, 1996–2001

Region	1996	1997	1998	1999	2000[a]	2001[b]
NIEs						
Indonesia	8.0	4.5	-13.7	0.5	3.0	5.0
Malaysia	8.6	7.5	-7.5	5.4	6.0	6.1
Thailand	5.5	-1.3	-10.0	4.0	5.0	5.5
Philippines (not defined as NIEs under the World Bank report)	5.8	5.2	-0.5	3.2	4.0	4.8
Transition economies						
China	9.6	8.8	7.8	7.1	7.0	7.2
Vietnam	9.3	8.2	5.8	4.7	4.6	4.5
Small economies						
Cambodia	7.0	1.0	1.0	4.0	5.5	6.0
Lao People's Democratic Republic	6.8	6.9	4.0	4.0	4.5	5.0
Papua New Guinea	3.5	-4.6	2.5	3.9	4.7	4.5
Fiji	3.4	-1.8	-1.3	7.8	3.5	3.0
Mongolia	2.4	4.0	3.5	3.3	4.3	4.5
Solomon Islands	0.6	-0.5	-7.0	1.0	2.0	3.0
North Asia HPAEs						
Korea	6.8	5.0	-5.8	10.2	6.0	6.1
Hong Kong, China	4.5	5.3	-5.1	2.0	5.2	4.4
Singapore	7.6	8.4	0.4	5.4	5.7	5.8
Taiwan, China	5.7	6.8	4.8	5.5	6.5	6.1
Industrial countries						

Region	1996	1997	1998	1999	2000[a]	2001[b]
Japan	5.0	1.6	-2.5	0.3	0.9	1.6
United States	3.7	4.5	4.3	4.1	4.3	n/a

Source: Stiglitz and Yusof (2001)

Stiglitz and Yusof (2001, p. 4) debated that "the economies of East Asia growing by close to 6 percent in year 2000, after attaining a growth rate of 4.1 percent in 1999 (Table 2.3), is there any need to rethink the East Asian miracle?" They further questioned if a year of low growth in 1998 during the Panic of 1997 be treated "as an inevitable bump on the road to globalization."

2.8 Globalisation to the *Ummah*

Globalisation to the Muslim communities or the *Ummah* had caused a lot of concern based on the majority perception that it would continuously serve as a tool to manifest the process of 'Westernisation' of Muslim communities. Westernisation is described as the supremacy over the international political economy via international establishments such as the IMF and World Bank. Nonetheless, the multi-facets of globalisation as hypothetically highlighted by many scholars is that the monetary attribute holds dominance in any globalisation discourse. In this situation, Muslim states have questionably been on the losing ground for many generations. Muslims have had hostile experiences with earlier stages of globalisation linked with colonialisation and the subsequent injustice felt under the controls of Western forces. This injustice is heightened by the vast vacuum between the wealthy West and the oppressed *Ummah*. Many secular-based studies have attributed the present Islamic revolution to this glaring inequality in material affluence, provoking resentment and dissatisfaction among unsatisfied urban Muslim adolescence (Amin, 2012; Achmad and Hamzani, 2016). Some of them have quoted statistics from Arab Human Development Report presented by Middle East social analysts for the United Nations to justify their opinion (Friedman, 2006; Singer, 2006). The Muslim scholars or *Ulama* have persevered to present justifications for the endless regression of the *Ummah*, who were accustomed with the condition that secular accomplishments were alongside with and emblematic of Islam's divine faith (Camroux, 1996; Askari *et al.*, 2013). Clarifications were pursued from both within and outside the doctrine of Islamic values, releasing a distinctive but corresponding path of globalisation highlighting Islam's universal principles. As the debate continues, with the pervasiveness of transnational economic structures indicating the effective outcome of the nation's globalisation efforts, the nature of Islamic harmony recommends Muslims the finest interface in their essential confrontation with an externally inflicted predicament of a laissez-faire capitalist (Evans, 2011).

2.9 Conclusion

The concept of the Islamic state is a dynamic global notion among Muslims. As a whole, Malaysia's political Islam had prevailed over alternative political beliefs. At the conceptual level, Southeast Asian Islam has the potential to govern with the diverse concepts that are presently globalised. Islam bears the inner abilities to maintain an effective reaction to such perceptions as democracy, human rights including women's rights, civil society and free trade (Bakar, 2010).

The concept of globalisation is not a concern for the *Ummah* as Islam is pro-globalisation. From the Islamic perspective of Southeast Asia Muslims, the principle of trade and business transaction should be just and fair, however the prevailing phenomena of global trade displays numerous unjust elements, especially the rapid growth of financialisation. Even the controversial Mahathir, despite his anti-West rhetoric, is not anti globalisation. He is merely against what he and many Muslims recognised as the exploitations and transgressions in the current practice of globalisation principally in the financial markets. The ultimate goal of an Islamic nation is the provision of universal goods for all people, not just what is known to be beneficial by one or two states. The Islamic viewpoint as interpreted from the Quran and *Hadith*, the nature of independent commerce in relation to globalisation and distribution of wealth, "wealth should not only circulate between the rich amongst you" (Quran, 59:7) and "Only a sinner hoards", a *Hadith* narrated by a Muslim (Drew, 2018).

Mahathir's depiction of "Islam cannot be described as merely the response to a stout challenge from oppositional Islamist"; and that the Malaysian state perhaps "didn't so much co-opt Islamists as it became Islamist." (Liow, 2009, p. 12). Whether or not Mahathir truly believed in or was "in any sense genuine about this representation is difficult to establish" and one can "merely identify core themes in his articulation of Islam." (Schottmann, 2018, p. 91).

CHAPTER 3: ISLAMISATION IN MALAYSIA

> "UMNO would like to state outright that Malaysia is an Islamic state. This opinion is based on the opinions of many ulama' in the past who have explained what Islamic state is."
>
> Mahathir Mohamad (2001)

> "When it is properly understood, and its true precepts are followed, it offers a path to enlightenment, to harmony, to stable and responsible government, to progress and to prosperity. Malaysia is an Islamic state. At the same time, and without contradiction, it is democratic, diverse, tolerant, peaceful, economically and politically stable, progressive and forward-looking. There is no inherent conflict between Islam and any of these achievements. In fact, we believe that the way we adhere to the essential or fundamental teachings and practice of Islam in Malaysia has contributed to our success as a nation." [14]
>
> Mahathir Mohamad (2002)

3. Introduction

This chapter explains the essential background of the underlying Islamic principles and the extent of its relevance in Malaysia's policy-making process. Muslims believe Islam advocates the guiding principles and lays down a set of rules for all facets of human life, including the economic aspect. How and to what extent would an economic and financial system constructed in compliance with the Islamic principles be diverse from a modern, conventional system?

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[14] Martinez (2001) argued that the "issue of the Islamic state has been at the forefront of Malaysian public discourse, but even more so since the announcement by Mahathir that Malaysia was already an Islamic state. The issue has evoked consternation and debate that is not reflected in the mainstream media, and which is symptomatic of the disjuncture between perceptions in public discourse and realities on the ground".

Efforts to explain the Islamic economic and financial principles and rules in modern analytical terms were only made in the past few decades. Iqbal and Mirakhor (2011)[15] had stated that despite considerable published research, there is still some misconception pertaining to the application of a precise definition to various social sciences prefixed with the word "Islamic", such as Islamic finance or Islamic economics. One of the key causes for confusion is the inclination to perceive various aspects of such a system in isolation, without considering it in its entirety.

The first half of the chapter examines the ideological underpinnings in devising the social, economic and financial system based on the tenets of Islam and its challenges. It will then analyse the legislative framework that governs the Islamic finance system in Malaysia that differentiates it from conventional banking and finance. This analysis is vital in understanding the significance of the divine law to the general Muslim in Malaysia. Given that the most distinctive feature of Islamic finance is the restriction on interest, it is necessary to give special attention to the analysis of this prohibition. The prohibition of interest or usury (*Riba*) is the ethical core of Islamic banking and not presented with any regulation based on human intelligence, but divine wisdom based on Islamic law, better known as Shariah. *Riba* is a term literally meaning "an excess" and interpreted as "any unjustifiable increase of capital whether relating to loans or sales". More precisely, any positive, fixed, predetermined rate tied to the maturity and the amount of the principal (i.e. guaranteed regardless of the performance of the investment) is considered *Riba* and is prohibited (Abdi, 2011).

The second half of this chapter gives the narrative on the history and early development of Islamic finance in Malaysia. It explains how the bloodshed caused by the ethnic riots in 1969 had enthused the need for an affirmative policy to alleviate the economic gap between the financially challenged Muslim Malay majorities and the wealthier Chinese

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[15] Iqbal headed World Bank's Global Islamic Finance Development Center in Istanbul, with earlier assignments in the World Bank Treasury and the Finance and Markets Global Practice. Mirakhor was the Executive Director of the IMF from 1990 until his retirement in 2008. Both of them had authored many articles and books on Islamic economics and finance.

minorities[16]. The affirmative policy known as the NEP had laid out the groundwork for Mahathir's Islamisation policy during the 1980s[17]. It further analyses the different phases of the development in Islamic finance, which will provide the crucial background in analysing the findings of this research (chapters 5 and 6).

Malaysia's Islamic banking milestone is described from the humble beginnings of a mere savings corporation for pilgrimage fund, that eventually transformed into a significant national investment corporation. It then focuses on the Mahathir administration[18] and the approach that he took in implementing the Islamisation policy. The series of events that took place, i.e. the establishment of NEP, the Islamic insurgence among the Muslim community and Mahathir's pro-Islamic approach in his administration had provided Malaysia with a firm foundation to grow into an Islamic finance hub in the region. Malaysia also became the first country to implement a dual banking system, where Islamic banking system operates in parallel with the conventional banking system (Ahmad Mokhtar, Abdullah and Alhabshi, 2008).

3.1 The Quran

Muslims believe that the Quran is the eternal words of God (Allah), containing revelations received by the Prophet Muhammad ﷺ via the angel Gabriel (Jibreel). The strong belief for Muslims in the divinity of the Quran was due to the eloquence of its language, the scientific facts it unravels (Bucaille, 2003) and the depth in its meaning (Pickthall, 1930). Muslims believe that all the prophets mentioned in the Holy books of Judaism and Christianity are messengers of God and that Prophet Muhammad ﷺ is the last messenger, with the Quran as the final guidance to all humankind to follow the correct path. The fundamental notion of Islamic finance is as old as Islam itself. Makkah, where Islam

[16] In 1970, Peninsular Malaysia had a population of 8.8million people, with 53% Malays, 36% Chinese, 11% Indian and less that 1% of other races (Department of Statistics, Malaysia, 1972 as cited in (Hirschman and Suan-Pow, 1979)).

[17] The NEP will be analysed in detail in Chapter 4 as it formed a crucial reason for Malaysia's policy decisions.

[18] Mahathir was the fourth Prime Minister after Malaysia reached its independence in 1957 and the Prime Minister during the Panic of 1997. He is currently the 7th Prime Minister for the second time.

originated in the 7th century was at the commercial crossroads of precious metal and spice market. Prophet Muhammad ﷺ was a merchant and a caravan trader before he was commissioned as the Messenger.

3.2 Prophet Muhammad ﷺ and early Islamic Economy

The revelation of the Quran to the Prophet Muhammad ﷺ took place in the midst of two trade cities of Makkah and Madinah, which had previously prospered through both local and international commerce. At that time, the financial needs of the merchants were mainly met via a framework of interest-based loans. After the evolution of Islam, there was an significant transformation in the financial system of these cities after the revelation of the Quranic verses that prohibit the dealing in usury/interest, the utilisation of certain goods and the rules of trade. These revelations had laid the groundwork of Islamic finance transactions. These principles were practiced effectively in the two cities and spread to other parts of the world for centuries. *Baitulmal* which was the central Islamic treasury intended for the benefit of the poor and needy in Prophet Muhammad's ﷺ government indicated that the development of the Islamic financial system was established during that era. The Prophet Muhammad ﷺ had the Madinah mosque to operate as the treasury but Sayiddina Omar, the second caliph, set up and managed *Baitulmal* as a separate entity.

Apart from the establishment of the *Baitulmal*, "historical evidence confirms the existence of Islamic financial transactions via the bill of exchange and cheques in the early days of Islam. For example, Ibn Abbas[19] received the silver dirhams and sent an acknowledgement to Kufa, a city in Iraq" (Nuhu Tahir, 2016). Similarly, "Abdallah Ibn Az Zubair[20] received cash in Makkah and wrote to his brother in Iraq who repaid the depositors when they arrived in Iraq" (Abdi, 2011). This is a brief account of simple Islamic financial transactions during the early era of Islam between the years 650 A.D to 750 A.D. The history and background of the Prophets, especially the Prophet Muhammad ﷺ are crucial elements in following his *Sunnah*[21]. It is because Muslims believe that Islam

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[19] Ibn Abbas is Prophet Mohammad's ﷺ cousin and close companion. He is also an Islamic scholar.

[20] Abdallah Ibn Az Zubair is a close companion of Prophet Mohammad ﷺ and a caliph during the Umaiyyad reign between 680 and 692.

[21] The *Sunnah* of the Prophet Muhammad ﷺ is the second fundamental source of Islamic law. It embodies the entire pattern of the life of the Prophet and includes every detail concerning his utterances, actions,

is not just a religion but a holistic faith and is governed by the divine law from Allah. The understanding of Shariah was initially direct from the knowledge of the Quran and *Sunnah*, then the knowledge was imparted authoritatively to later generations via the system of *Fiqh* which had been analysed in detail and is ultimately based on the reliable *Ijma* and Q*iyas* (consensus and analogy) (Imamuddin, 1991). All entities in the financial system must function in conformity with Shariah and decisions cannot be profit-oriented on an entity's interest alone. However, Islam encourages trade and does not restrict profit-making so long as it is not against the best interest of the community (*Maslahah*). The overarching concept of Shariah is based on the believe that men are appointed as *Khalifah* and do not have absolute ownership of their properties but act as custodians.

3.3 Understanding the "Islamic Economy"

Muslims believe that Islam is a religion that applies to all facets of one's existence, and it holds a high value to the admission of just and fair to all individuals. An *Islamic Economy's* key attribute is the intention to produce a just, true, good and harmonised community as seen by Islamic ethical sense. Shariah affirms that Islamic dealings must be managed and built on ethical models and social duties, and further must be prepared on Shariah's moral groundwork (Grassa, 2013). The teachings in Islam have been broadly described and support all the conventions behind corporate governance, by underlining the importance of qualities, integrities, and ethics for the benefit of a community ''Each one of you is a guardian, and each guardian is answerable to all under his care''[22]. Shariah is an Arabic word that means a waterway that leads to the main river or a road to the right path. For a Muslim, it is the principal guidance and the way of life, filled with intent and just as prescribed by God through the Quran and *Sunnah*, and extends to every aspect of daily life including commercial and financial undertakings.

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conduct and his attitudes whether explicit or implicit. Every aspect of his life and conduct has been reported in a vast collection of Hadiths and every Muslim believes in the *Sunnah* of the Prophet, in addition to the Quran (Mackeen, 1984).

[22] Hadith Narrated by Abdullah bin Umar, compiled by Sahih Bukhari (46:370).

3.4 Sources of Shariah

The Quran and the *Sunnah* are the primary sources of Shariah. They are thought to contain God's infallible and immutable will, or Shariah in a narrow sense. However, the Quran and the *Sunnah* are silent on certain contemporary issues. It was Imam al-Shafii in the early ninth century (the founder of Shafii school of law, see below) who "authoritatively insisted on human reason as the final judgement on matters not regulated by the Quran" (Hallaq, 1997, p. 21). Imam al-Shafii stated that there are two secondary sources of law: *ijma, or* consensus*,* and *qiyas,* or analogy. Together with the primary sources, there are the other principals of *Usul al-Fiqh* or Fundamentals of Jurisprudence (Figure 3.1 and 3.2).

Figure 3.1: The Sources and Techniques of Shariah

Primary Sources

The Quran (the book containing the message of Islam). Muslims believe that it is the word of God as conveyed to the Prophet Mohammad ﷺ.

Sunnah (collection of the words or acts of the Prophet or the *Hadith* which Prophet Mohammad ﷺused to give moral guidance on many issues)

Secondary Sources & Techniques

- ✓ *ijm*a (consensus)
- ✓ *qiyas* (analogy)
- ✓ *istihsan* (juristic preference)
- ✓ *istislah/maslahah* (public interest)
- ✓ *ijtihad* (interpretation or deduction)

Figure 3.2: Description of Secondary Sources & Techniques

Sources/ Techniques	**Description**
Ijma (consensus)	It means the educated consensus of *Ulama* (learned Muslim scholars), on the application of Shariah to worldly affairs. In Islamic finance, this is crucial as models and products of Islamic banking are not discussed in either the Quran or in the *Hadith*, the primary sources which govern the system. Consequently, the evolution of Islamic banking has been based to a substantial degree on the consensus of modern Muslim scholars and jurisprudence at both national and global levels. Hence agreements formed were based on *ijma,* i.e. the joint consensus of the *Ulama.*
Qiyas (analogy)	Analogical deduction i.e. additional sources of law are *qiyas* (analogy from established law)
Ijtihad (interpretation or deduction)	*Ijtihad* (from the root *jahd*, meaning "struggle") plays a critical role in deriving rules for resolving issues arising from time-dependent challenges. *Ijtihad* refers to the efforts of individual *Ulama* and scholars to find solutions to problems that arise in the course of the evolution of human societies and that are not addressed specifically in the primary sources. *Ijtihad* is based on the earlier consensus of *Ijma'*, *Qiyas*, *Istihsan*, *Maslahah* and customs (*Urf*). Secondary sources of the Shariah must not introduce any rules that are in conflict with the main tenets of Islam (Iqbal and Mirakhor, 2007, p. 8)
Istihsan (juristic preference)	It points to exceptions that a jurist can make to a strict or literal legal interpretation (Yavuz and Esposito, 2003)). *Istihsan* can be applied to *Qiyas*, or any other method, and does not provide a definite answer.
Istislah or Maslahah (public interest)	Literally means 'seeking the good' (Ramadan, 2003), or taking the public interest, *Maslahah* into account. However, some *Ulama* have differed over the scope of *Istihsan* or *Maslahah* as a source of law.

Source: Hassan and Lewis (2007) and author's research

3.4.1. Schools of Islamic jurisprudence

The English term "Islamic Law" masks a vital difference between Shariah (divine law) and *Usul al-Fiqh* (the human apprehension of that law) as *Fiqh* can be slightly inaccurate, diverse, vague, and evolving. The norm is that *Fiqh* rulings have ambiguities and only probable assumptions as to what God's law actually is and consequently certain doctrine of *Fiqh* literatures from qualified scholars have a mixture of opinions.

Classical Islam had no ecclesiastical hierarchy nor a central authority to publicise official doctrine as compared to Christianity (Abdi, 2011). The closest to priesthood in Islam are the jurists known as the *Ulama,* who to some extent differ in their functions and degree. Islam is divided into two main sectarian divisions that separate Sunni and Shiite believers, which arose in 661 AD on the question of the rightful leadership of the community. Shi'ism, which has various sub-sects, is predominantly in Iran, and has a significant number of followers in Iraq, India and many of the Gulf States. However, the majority of Muslims are from the Sunni believers (85%) and the Sunni legal doctrine has four main schools of thought or *Mazhabs*, each with its own ideological system and applications of law, but acknowledges the validity of each other's judgements. The four orthodox schools of thoughts (*Mazhabs*) are:

Mazhabs	**Founder or Imam**	**Key characteristics**	**Geographical location**
Hanafi	Imam Abu Hanifa, a Persian who taught in Iraq and died in 767. The earliest of all four schools.	The most flexible of the four *Mazhabs*, emphasising private interpretation (*Ray')*, *Istihsan*, and *Qiyas*. *Ijma* is also accepted.	India and the Middle East.
Maliki	Imam Malik ibn Anas, died in 795 in Madinah.	The Maliki school accorded preference to *Qiyas* over weak *Hadith*[23] (Al-Mukhtar Al Salami, 1999, p. 22). The Malikis firmly rely on both the *Hadith* and on *Ijma* of the *Ulama of Madinah*.	Mostly in North, West and Central Africa.
Shafii	Mohammad ibn Idris al Shafii (Imam Shafii), an Arab who died in 819 or 820 in Egypt and was a pupil of Imam Malik.	Imam Shafii is considered being the most distinguished of all imams as he was recognised for his modernisation and balanced judgment. He refused to accept any independent reasoning i.e. the personal opinion of scholars (*Ijtihad bil* al-*ray*), *Istihsan* and *Istislah*, but fully consented to *Ijma*.	Predominately in Malaysia, Indonesia, Yemen, Egypt and Somalia.
Hambali	Disciples of Ahmad ibn Hanbal (Imam Ahmad),	The Hambali base themselves exclusively on the Quran and the Sunnah, and the only *Ijma* that is	Predominantly in Saudi Arabia.

[23] A weak Hadith is a Hadith with a weak chain of transmitters.

Mazhabs	Founder or Imam	Key characteristics	Geographical location
	who died in 855 in Baghdad.	accepted is the consensus of the Companions of the Prophet, among whom the rightly guided Caliphs.	

Source: Hassan and Lewis (Hassan and Lewis, 2007)

3.4.2. Relevant principles from the Quran and Hadith

Muslims strongly believe on the concept of being accountable for your own actions in this life and this belief has strong implications on how corporate governance is observed, notably in financial services. The Islamic financial industry's primary challenge was the transforming of traditional financial products into Shariah compliant clones, especially matters relating to the ban on usury or ''*Riba*''. There has also been an inclination to integrate corporate governance principles as Shariah provisions, and to the guidance of the Quran and *Sunnah*. The AAOIFI[24] and IFSB[25] have intervened and published corporate governance guidelines for Islamic financial institutions (Magalhães and Al-Saad, 2013).

The term *Islamic economics* relates to the science and study of the rules and regulations of the Shariah in the procurement and removal of resources in bringing gratification to individuals and facilitate them to carry out their duties and responsibilities to Allah and the *Ummah*. Islam assumes a unique nexus of contracts among the Creator, man and society on the basis of the divine law that directly affects the workings of the various social, political, economic and financial systems (Iqbal and Mirakhor, 2011). Therefore, in understanding the way that an economic system be structured under the Islamic principles, it is necessary to appreciate the nature of this relationship. In the Quran, Allah says: "But seek, through that which Allah has given you, the home of the Hereafter; and [yet], do not forget your share of the world. And do good as Allah has done good to you.

[24]Accounting and Auditing Organisation for Islamic Financial Institutions (AAOFII) is a Bahrain based non-profit organisation that was founded to retain and promote Shariah accounting standards for Islamic banks, participants and the overall industry.

[25] The Islamic Financial Services Board (IFSB) is a Kuala Lumpur based non-profit organisation that sets standards and offers guidance for Islamic banking and finance regulatory and supervisory agencies.

And desire not corruption in the land. Indeed, Allah does not like corrupters" (Quran 28:77).

3.4.3. The underlying principles of Islamic banking and finance

Islamic finance is distinguished from conventional banking by its predominant requirement that every transaction under Islamic finance must be Shariah-compliant. Even though the general perception of what makes up Islamic finance is the ban on interest, there are other guiding principles that must be strictly followed to be in compliance with Shariah (Shaikh, 2010; El-Galfy and Khiyar, 2012, pp. 944–945; Elasrag, 2014; Vicary Abdullah and Keon, 2014, pp. 4–7; Franzoni and Allali, 2018, pp. 3–4; Habib, 2018, pp. 3–4).

i) **Believe in divine guidance**, is the most crucial and forms the foundation of a Muslim's core belief. In Islam, the believers (Muslims) via self-regulation will conduct their trade and finance in accordance to the general teachings of the Quran and *Sunnah*. The Islamic economic system requires the community to uphold Islamic values and given that Islamic banks and other Islamic financial institutions are part of this economic system, the rules of Shariah is strictly complied. In contrast, religion and government are kept separate and independent of each other in the conventional financial system as the Western culture puts a high value on religious freedom and secularity in the state (Vicary Abdullah and Keon, 2014).

ii) **Prohibition in interest**—this is the fundamental characteristic that distinguishes it from conventional banking and will be discussed in greater length in the next section.

iii) **Financing is linked to real assets**. This principle will curtail excessive credit expansion and speculation as all Islamic financial instruments must be based on real assets, which can only expand with the rise of the real economy. There will be an exchange of goods and services and any unwarranted asset price inflation will be minimised. On the contrary, traditional financing activities can magnify faster than the real economy as there are no real assets attached to the transaction. Financial products can grow exponentially leaving the real economic growth far behind, which can be highly risky for a state if not closely regulated. Refinancing of debts or loans not based on real assets would have not been allowed under Shariah.

iv) **Prohibition of *Haram*[26] and unethical investments**. Shariah forbids any investments in companies that are involved in *Haram* products such as alcohol, tobacco, pork, weaponries or pornography. Investments should be for a well-intentioned purpose and are very similar to the conventional concept of corporate socially responsible investing with the aim to maximise both financial gain and social benefits.

v) **Prohibition of speculative or extremely risky investments**. The Quran clearly prohibits profit based on speculation (*maysr*), *maysr* is directly translated from Arabic to mean easy and effortless earnings. This involves the restriction on taking unreasonable risks or the undertaking to gain wealth by speculating on a probable event. An equally crucial restriction for the legality of a transaction is uncertainty (*ghàrar*). The prohibition on *ghàrar* predominantly involves the components and essence of contracts of the Islamic financial products. Islamic finance requires the contracts not to incorporate components of uncertainty to the fundamental parts of the contract, for example, uncertainty in the structure of the contract and aleatory contracts. Comparing this prohibition to *ghàrar*, *maysir* is more focused on the human behaviour and the relative impacts on the community. Transactions that involve speculation, gambling or wagering bets are prohibited as they are considered as an enhancement due to chance, for example, speculative contracts such as hedging transactions and derivative products such as swaps are not permitted under Shariah.

vi) **Profit and loss sharing**. Islam advocates a system based on risk-sharing, fair trade and fairness, both in the financial and social-justice sense. Some Islamic scholars even to the extent believe that the practice of risk-sharing is superior on

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[26] In Arabic, *Haram* refers to anything that is forbidden under Islam. It is the opposite of *Halal*, which refers to anything that is permissible under Islam, that includes aspects of human conduct, apparel, language and food.

several counts as it leads to more cautious lending by encouraging banks to invest directly in an entrepreneur's ventures (Useem, 2002).

3.4.4. The religious ban on *Riba*

Islam is a monotheistic religion and shares the same historical origins as Christianity and Judaism. There are many common beliefs among these three religions, and mutual veneration for the biblical prophets is one of them. Muslims believe that Jesus (Isa) is a prophet of Allah but strongly reject that he was the son of God. Muslims believe in the oneness of God and strongly reject the concept of the Trinity. Muslims also believe that the Prophet Muhammad ﷺ, Jesus and Moses are prophets of God and occasionally known as the Abrahamic religions that continued to spread the message on the oneness of God (Calder, 2016). One distinct message that was initially brought up by all three religions is the prohibition of usury, with variation in context from setting the rules of borrowing and lending to the description of both positive and negative consequences of the practice of usury (Abou-Zaid and Leonce, 2014).

These three monotheistic religions have an extremely distinct viewpoint on the practice of charging interest on loans or funds borrowed. In their religious books, the Talmud (Oral Torah), the Torah [27], the Bible and the Quran, the prohibition on interest /usury is evident and mentioned multiple times. One would instantly conclude that the practice of usury is dreadfully forbidden by these three religions and the severity of the warnings were expressed explicitly against any engagement in usury (Abou-Zaid and Leonce, 2014, p. 220).

> "But love your enemies, and do good, and lend, expecting nothing in return, and your reward will be great, and you will be sons of the Most High, for he is kind to the ungrateful and the evil." (Luke 6:35).

[27] The five books of Moses, the entire Jewish bible or the Old Testament.

> “Then I consulted with myself, and contended with the nobles and the rulers, and said unto them, Ye exact usury, every one of his brethren. And I held a great assembly against them” (Nehemiah 5:7).

However, the ban on usury had survived resiliently in Islam as there were still significant numbers of Muslims who still considered it to be impious. However, in Judaism and Christianity the ban on usury had significantly diminished and not considered as irreverent. Calder (2016) concluded in his study that the survival of the ban on usury depends on the fate of its clerics and amongst the three Abrahamic religions, only the Muslim *Ulama* had endured the test of time and the challenges of modernity. Despite the fact that both pre-Islamic Abrahamic religions severely forbid interest-based contracts, the prohibition has been wielded over time and was ultimately repealed. The holy books of the Judaism were the first to introduce the interest prohibition and the Old Testament indicates that all Jews are “brothers” and that interest-based activities are only forbidden among them (Ahmad, 1981). However, a study of the relevant parts of the Old Testament indicates that it literally refers to all forms of lending although the clerics claimed that the restriction only involves the Judaic brotherhood.

Whilst in Christianity, the Church remained adherent to the ban for a long time and continued in effect up to the Medieval Age. This was due to the clear prohibition as revealed in the Gospel of Luke. However, after the upsurge of Protestantism, the ban was abolished gradually as “the church was forced to endorse interest-based transactions” (Bayindir and Ustaoglu, 2018, p. 283). The financial system reached an institutional framework with the advent of the industrial revolution and subsequently became prevalent and efficient in the economy (Persky, 2007). Bayindir and Ustoaglu (2018) claimed that interest had developed into an essential part of the system to the extent that without it, the system would undoubtedly fail.

3.4.5. Interest free banking (*Riba*-free banking)

The promoters of Islamic finance’s primary concern on *Riba* is that interest exemplifies financial exploitation and injustice. Given that Islam upholds fairness and is against any type of oppression, the archetypical argument is that any form of *Riba* is forbidden. Thus, the intention of these advocates is to restructure banking and finance away from the conventional interest-bearing activities and channel activities on an alternative approach consistent with Shariah rules.

> **The Quran:** "O you who believe! Have fear of Allah and give up what remains of what is due to you of usury. ... If you do not, then take notice of war from Allah and His Messenger." (Quran 2:278)
>
> **The *Hadith*:** The Prophet said, "Avoid the seven great destructive sins." They (the people!) asked, "O Allah's Apostle! What are they?" He said, "To join partners in worship with Allah; to practise sorcery; to kill the life which Allah has forbidden except for a just cause (according to Shariah); to eat up usury (*Riba*), to eat up the property of an orphan; to give one's back to the enemy and freeing from the battle-field at the time of fighting and to accuse chaste women who never even think of anything touching chastity and are good believers."[28]

Riba is considered one of the greatest sins that can be committed by a Muslim as both the Quran and *Hadith* had clearly warned the believers of its severity. *Riba* in Islam means lending to those who needed money to meet their basic requirements and charging them "interest" on the amount given out as loan. It means taking advantage of the poor and benefiting from it financially. Usury/interest is the foundation of the conventional banking system as it permits the charging of interest as well as minimising the risk to the banks via the holding of collateral. For banks, the downside risk is limited by the value of the collateral held and the benefits are almost guaranteed. *Riba* literally means increase, extra or addition (Cagatay, 1970) and in the financial sense, *Riba* is any increase of earning or income obtained from a loan.

> In a verse revealed in Makkah, "And whatever you give for interest to increase within the wealth of people will not increase with Allah. But what you give in *Zakat*[29], desiring the countenance of Allah - those are the multipliers." (Quran, 30:39).

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[28] A hadith compiled by Sahih Bukhari 82:840, narrated by Abu Huraira RA.

[29] *Zakat* in Arabic means *'that which purifies'* and is a form of alms giving. In Islam, it is a religious obligation which is equivalent to tax and is the third pillar of the five pillars of Islam, in order of

3.4.6. Conceptual differences between Islamic and conventional banking

Conventional banking is based upon financing profitable projects with interest lending. Islamic banks avoid *Riba* and instead invest on a profit or loss basis. Typical types of contracts include leasing (*Ijarah*), purchase and resale transactions (*Murabahah*), profit and loss sharing (*Mudharabah*), trust financing or limited partnership or joint venture investment *(Musharakah)*.

The primary conceptual difference between an Islamic Bank is its social objectives. For instance, conventional banks normally expect potential borrowers with a business proposal to have some collateral before funding is given. Irrespective of the project's profitability, interest will continually be charged. The objective of a conventional bank is to finance the most economical and profitable projects. Clearly, from the perspective of developing 'banking-relationship', the banker would prefer the project funded to turn out well.

On the other hand, Islamic banks financing can be designed so that the bank takes on a more active role with the customers via profit and loss sharing arrangement. Islamic current accounts do not pay any reward and are only used for liquidity purposes, hence there are no profits to share. Savings accounts holders may accept a return on investment called *Hibah*. While an investment account draws a bigger dividend, but they also bear the risk of any loss in their investment if the bank suffers a loss and money must be invested for a minimum time range. For larger investors, advance investment accounts would be available. Similar to "conventional banks, Islamic banks can run a banking and a trading book. This means that they can also deal with off-balance sheet contracts such as letters of credit, foreign exchange and financial advisory" (Hassan and Chowdhury, 2004). Another feature in contrast to conventional banks, Islamic banks have an ethical charter i.e. unethical activities such as gambling, alcohol or pornography are prohibited as outlined by the Quran. As part of their social obligation, Islamic banks will assist with the payment of *Zakat*. Normally Islamic banks have a Shariah board to ensure that

importance. *Zakat* is an obligation for all Muslims who meet the necessary criteria of wealth, and the beneficiary shall be '*the poor, the needy, the Amil, those whose heart are inclined towards Islam, the slaves, the debtors, those who fight for Allah's cause and the wayfarer*' (Quran: 9:60).

banking activities and bank practices comply with Shariah. A greater social status is expected of Islamic banks in a Muslim society as compared to conventional banking (see Table 3.1). Ahmad and Hassan (2005) indicate that as Shariah principles demand social justice, Islamic banks correspondingly take on the obligation below:

i) Islamic banking has certain philosophical missions to achieve. That is, since God is the Creator and Ultimate Owner of all resources, institutions or persons have a viceregency role to play in society. Therefore, Islamic banks are not free to do as they wish; rather they have to integrate moral values with economic action;

ii) The ability to provide credit to those who have the talent and the expertise but cannot provide collateral to the conventional financial institutions, thereby strengthening the grass-root foundations of society; and

iii) The duty to create harmony in society based on the Islamic concept of sharing and caring in order to achieve economic, financial and political stability.

Table 3.1: Fundamental differences between Islamic & conventional banking

	Islamic banking	**Conventional banking**
1.	Interest or any usury based transactions are prohibited in financial transactions	All financial transactions are based interest and high-level usury
2.	Depositors bear the risk, no need for deposit insurance	Depositors do not bear any risk, moreover the bank is obligated to repay principal with a guaranteed amount
3.	Try to fulfil the objectives of Shariah in ensuring social justice and welfare	Not Applicable
4.	Monitor the legitimacy criteria fixed by the Shariah for production and investment	Not Applicable
5.	Islamic banks work under the supervision of the Shariah Supervisory Boards	No such supervision
6.	Carry out investment schemes to promote the income of the people below the poverty line, under the principles of *Mudharabah* and *Musharakah*.	No such plans

	Islamic banking	Conventional banking
7.	Islamic banks become partner in the business of the client, risk and rewards sharing	Loss is solely clients' responsibility
8.	Speculative financial activities is prohibited	Some functions are speculation-related
9.	Bank pays *Zakat* on income and inspires clients to pay *Zakat*, which ensures redistribution of income in favour of the poor	No *Zakat* system
10.	The basis of business policy is the socio-economic uplifting of the disadvantaged groups of the society	Profit is the prime target of business, or the prime duty is to maximize the shareholders' value
11.	Dual target: implementation of the objectives of Shariah and profit	Profit making is the sole objective
12.	Islamic banks sell and purchase foreign currency on a spot basis, not on forward looking or future basis	Spot and forward are both used

Source: Hassan and Lewis (2007, p. 98) and researcher's analysis

3.5 Islam in the world today

Currently there are approximately 2 billion Muslims globally[30], making Islam the second-largest religion in the world behind Christianity, with the majority living in the Indian subcontinent and Southeast Asia (Devetek, Burke and George, 2008). Countries with Muslim majorities are generally identified as Islamic States, irrespective of state and political structure (Al-Turabi *et al.*, 1983). The Muslim migration in the late 20th century had contributed to the rise of Muslim population in the US, Europe and Australasia. The movement to Europe was strongly connected to colonial legacies as the largest Muslim

[30] The global population increased from 2.53 billion (1950) to 7.88 billion (2020). In the same period from 1950 to 2020, the Muslim population increased from 0.43 billion (17%) to 2.04 billion (26%) with the majority of Muslims live in Asia (71%), Africa (23%) and Europe (6%). The largest Muslim country is Indonesia, with an estimated population of 232million in 2020, about 13% of the world's population of Muslims, followed by Pakistan (1 1.1%), India (11.1%), Bangladesh (9.3%), Egypt and Nigeria (5%) (Kettani, 1950; Neumueller, 2012).

population in the UK are from South Asia, while Algerian Muslims currently comprise a significant group in France. The rapid growth of Muslim minorities in non-Muslim countries is becoming progressively heterogeneous in ethnic tradition and ideology.

Islam arrived in the Saudi Arabia in the 7th century and rapidly expanded to other parts of the regions. The civil wars and World War 2 had caused the diaspora of Muslims to Europe and afterwards to Northern America and Oceania (Akbarzadeh, 2008). Whilst the rising phenomenon of present-day conversion to Islam (Neumueller, 2012) now forms an ethnically diverse international society of faith. Today, we see the development of Islamic finance into formal institutions in most of the Muslim countries and countries in Europe and North America. There were 505 Islamic banks in 2017 (including 207 Islamic Banking windows) with Islamic banking assets worth USD 1.72 trillion or 71% of the total Islamic finance industry (Research and Markets, 2019, p. 16). Its evolution is considered a significant Islamic phenomenon that had gradually gained global momentum.

3.6 Malaysia: Islamisation Policy

The root of Islamisation policy in Malaysia goes back to the civil disturbances in the late 1960s between the Muslim Malays and ethnic Chinese. During that time, the Muslim Malays were against the monopolistic control of the commercial sector by the Chinese and were also displeased with the increased Western influences in what was seen as corrupting the moral and cultural life of the nation (Venardos, 2005). After the ethnic riot in 1969 between the Malay majority and Chinese minority, the NEP was established to rectify the economic imbalance of the Malays as compared to other communities, especially the ethnic Chinese. The NEP’s ultimate objective was to foster national unity and nation building via the eradication of poverty and economic restructuring through the removal of ethnic identity with economic function and geographical location (Rasiah and Shari, 2001; Doraisami, 2005a).

The earliest record of a formal Islamic banking and finance in Malaysia can be trailed back to 1963 when the Pilgrimage or *Hajj* Fund or better known as *Tabung Haji* was set up by the government. Tabung Haji is a dedicated investment fund that offers Muslims a more systematic way of saving their money with the ultimate intention to perform their pilgrimage (*Hajj*) to Makkah[31]. The establishment of such an institution would assist Muslims to engage in Shariah compliant investment opportunities that they would otherwise miss out. Subsequently, Tabung Haji's outstanding achievement had motivated the government to set-up a National Steering Committee on 30 July 1981 to analyse the concept of building an Islamic financial framework in Malaysia.

The introduction of the Islamic Banking Act of 1983 was the entry point of a formal Islamic banking infrastructure into Malaysia and had simultaneously established Bank Islam Malaysia Berhad (BIMB). The act was a part of the Malaysian government's policy to help Muslim Malays who were regarded as financially disadvantaged to the more commercially inclined Chinese[32]. However, the approach towards a more *Islamic economy* and its actual reform plan only started in 1981 when Mahathir became Prime Minister. The Mahathir administration had called for an Islamisation policy to capitalise on the tenets of Islam as a positive ingredient in the development of the nation and its people. This approach was taken in order to restore economic imbalances and social disparity between ethnic groups, in particular the Muslim Malays and the more prosperous Chinese community.

As part of the Islamisation policy, Islamic establishments were set up to encourage savings and investment of Muslim Malays, especially those who opposed to conventional banking. From 1980s onwards, Islamic banking and *Takaful* (Islamic insurance) was developed in Malaysia since the establishment of the Islamic Banking Act in 1983. This was a result of the manifestation of the Islamisation policy under the Mahathir administration (Billah, 2007). The Islamic Banking Act gave Malaysia's BNM the power to regulate and supervise all Islamic banking activities, while the separate Islamic legislation and banking regulation existed in parallel with the existing conventional banking framework.

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[31] The performance of Hajj is the last pillar of the five pillars of Islam.

[32] It is the Chinese who control the business sector and played a prominent role in the industrial development and commercial prosperity of Malaysia, although Malays are the majority of the country's national populace

3.7 BNM: The Dual Banking System

The Central Bank of Malaysia, known as BNM was instituted on 26 January 1959 via the Central Bank of Malaya Ordinance, 1958 (CBO). The CBO was revised in 1994 and is now the Central Bank of Malaysia Act 1958 and defines BNM as the apex of Malaysia's monetary and banking framework with the interdependent objectives (BNM, 1999c):

- Issue currency and keep the reserves safeguarding the value of the currency;
- Act as a central banker and financial adviser to the Government;
- Promote monetary stability and a sound financial structure; and
- Influence the credit situation to the advantage of Malaysia.

Due to its function as currency issuer, BNM has the principal obligation to safeguard the stability of domestic prices to ensure that the economic development benefits are preserved. Monetary stability is reliant on the existence of a sound financial system for the effective conduct of monetary policy. In comparison to sophisticated industrial economies like the HPAEs that have sophisticated financial structures, BNM has a broader function in improving the financial framework which includes establishing the necessary monetary procedures in the capital markets. BNM's function is also to improve the solidity of the financial system to support the efficiency of the intermediation process so that national savings are mobilised and transmitted to investors, thereby adding to the overall development in investment and productivity (Khiyar, 2012).

Meanwhile, the Islamic Desk under BNM which was first set up in 1990 under the domain of the formerly Banking Unit (now Investment and Treasury Unit), was moved to the Bank Regulation Department in order to serve as a one stop centre to formulate policies and to process applications pertaining to Islamic banking operations. Previously, two separate sections handled the Islamic banking operations, namely, the Banking Operations Section in Bank Regulation Department and the Islamic Desk in the Banking Department. Currently, the Islamic Banking Section is responsible for planning and developing strategic and prudential policies on Islamic banking as well as monitoring the Islamic banking operations of banking institutions and Bank Islam Malaysia Berhad. The section's role has now expanded to serve as the secretariat for the National Advisory Council for Islamic Banking and *Takaful*.

BNM as the governing body for the financial institutions in Malaysia must ensure that the Islamic financial institutions' operations and activities are in compliance with Shariah rules and thus it had instructed all Islamic financial institutions to establish a Shariah Supervisory Board. The Board's key role is to review and endorse that newly launched products and services are in compliance with Shariah. The fundamental aspiration of BNM was to set up an Islamic banking system to operate correspondingly with the traditional structure. A complete banking system would expect 3 essential elements before it can be defined as a system, as an individual bank does not represent an entire structure (Laldin, 2008; Khiyar, 2012). These three elements are:

i) a considerable number of participants (financial institutions); a wide range of financial products;

ii) an Islamic money market; and

iii) a system that manifests the socio-economic values in Islam and must be Islamic in both substance and form.

Identifying the above requirements, the Malaysian government embarked on a steady method to reach the goal of firming up an Islamic banking system to supplement the conventional banking. Yielding from nearly 20 years of experience with Tabung Haji, the Malaysian government gained more confidence in proposing a further structured blueprint of developing the Islamic financial framework via the central bank. BNM adapted several principles and approaches in developing the blueprint and had decided to use the dual banking system approach. The blueprint to create a new full-fledged Islamic banking and financial system can be broken down into four phases (Ahmad Mokhtar, Abdullah and Alhabshi, 2008; Laldin, 2008; Khiyar, 2012):

i) Phase One - Foundation years (1963 -1982)

ii) Phase two - Development phase (1983-1992)

iii) Phase Three - Take-off phase (1993-2002)

iv) Phase Four - Liberalisation phase (2003 until present)

3.7.1. Phase One (1963 -1982): The Pilgrimage Fund

The birth of Tabung Haji signals the early attempt in developing Islamic banking in Malaysia. The inspiration for a pilgrimage fund began by a working paper titled, ''Plan to Improve the Economy of Prospective Pilgrims'' presented by the Ungku Aziz[33] in 1959 (Sa'ari and Borhan, 2005). The Tabung Haji project started at the end of 1962 and Tabung Haji was formally launched in 30 September 1963, providing Shariah compliant saving facilities. The idea was advocated out of the requirement to foster a way to aid Muslims to save up for their pilgrimage in a non interest-bearing institution. As the pilgrimage is considered a sacred journey, many Muslims previously had refused to keep their money in banks and resorted to diverse traditional means, some to the extent of keeping money under their pillows and mattresses (Sa'ari and Borhan, 2005). When funds were insufficient, some Muslims had resorted in selling their land and other assets (Islahi, 2018). Such traditions had caused adverse financial impact and undesirable social consequences on their financial well-being, especially after returning home.

As an economist, Ungku Aziz highlighted that the plight of the poor Muslim to perform the pilgrimage would not only deteriorate the rural economic structure, but consequently endanger the country's economic development (Laldin, 2008). The task of setting up Tabung Haji signified an important milestone not just in Malaysia but in other Muslim countries, and a challenging task. When it was deliberated in August 1962, it was overlooked until Ungku Aziz put forward the idea of forming a Pilgrims Saving Corporation to the government. He highlighted that Muslims with the intention to perform the pilgrimage or *Hajj* should be assisted to ensure that they will not be impoverished and safe from financial difficulty on their return. In the proposal, he suggested that future pilgrims should save in a bank that yielded profits but free from interest. This suggestion resulted in the notion of creating a Pilgrims Saving Corporation, an institution with a specific purpose. The concept paper on Tabung Haji was drawn up and presented to the rector of Al-Azhar University of Cairo in 1962 during his visit to Malaysia. After reviewing the concept paper, he was satisfied and believed that the proposals made were

[33] Ungku Aziz, born in London is a prominent Malaysian economist and a reputed academician and an authority on rural economy. He is the former Vice-Chancellor of the University of Malaya from 1968 to 1988 and he was awarded the title of Royal Professor in 1978. (https://www.thepatriots.asia/)

Shariah compliant (IRTI, 1995). Hence, the Pilgrims Saving Corporation was incorporated and 6 years later the Corporation was integrated with the Pilgrims Affairs Office[34] and was instituted into the Pilgrims Management and Fund Board by the Act of Parliament[35]. As the Muslim community in Malaysia expanded, there was demand for an institute that can protect their savings and that gives assurance that its activities are independent from *Riba* and are in accordance with Shariah principles. The primary aim of setting up Tabung Haji according to the Tabung Haji Act (1969) were:

i) to encourage Muslims to save regularly to aid their expenses during *Hajj* and for other good purposes;

ii) to permit Muslims to have dynamic and practical involvement in investment schemes acceptable in Islam through their savings;

iii) and to preserve and safeguard the interest of pilgrims by arranging various amenities and services during their *Hajj* (Laldin, 2008).

The financial role of Tabung Haji can be segregated into two key considerations. The first consideration is the administration of the funds, which includes the depositor's savings and withdrawals, and the second consideration is management of the investment of the funds. Tabung Haji has a holistic ambition to encompass all economic activities related to Islam, ranging from personal finance to religious tax, as well as from pilgrimage to investment. It is important to acknowledge how well it serves and prepares the pilgrims throughout the years. From a modest deposit of only RM46,610 (USD15,226) placed by 1,281 depositors in its first year of operation, Tabung Haji had more than 9.3 million depositors with RM73 billion (USD18 billion) funds in 2017 (Tabung Haji, 2017). Table 3.2 summarises the number of depositors and deposits over the years.

Table 3.2: Summary of Tabung Haji's Performance

Year	Total number of depositors	Total of deposits (RM)
1963	1,281	46,610
1964	6,566	816,146

[34] Which had been in operation since 1951 in Penang.

[35] Under the Laws of Malaysia Act 8, the Pilgrims Management and Fund Board 1969 and Act A 168, the Pilgrims Management and Fund Board (Amendment 1973).

Year	Total number of depositors	Total of deposits (RM)
1990	1.7 million	1 billion
2008	4.7 million	17 billion
2009	5 million	23 billion
2012	8.2 million	38 billion
2013	8.3 million	45 billion
2014	8.6 million	54 billion
2015	8.8 million	62 billion
2016	9.1 million	67 billion
2017	9.3 million	73 billion

Source: Cizakca (2011: 216-217); Handley (1997); Tabung Haji (2017)

Savings for *Hajj*

Tabung Haji's membership is restricted to only Muslim citizens in Malaysia, with a minimum deposit of approximately less than USD3 (RM10) to open an account. To facilitate the savings for the Muslim communities, with the majority being outside of Kuala Lumpur where Tabung Haji is located, Tabung Haji managed a good network across the country. Savings can be made via the following channels:

i) Tabung Haji branches;

ii) Post offices nationwide;

iii) Monthly salary deductions by their employers;

iv) Deposits via mailing; and

v) Various programs for dependents of the depositors.

Tabung Haji uses the Shariah principle of *Wadiah al-Wakalah*, that involves new depositors to agree to an *Aqad* statement or a statement of consent. The rule of *Aqad* implies that depositors grant permission for Tabung Haji to manage and invest the funds. Tabung Haji will distribute any profit received from these investments among the depositors as bonus payment. Additionally, Tabung Haji pays the Islamic tax or *Zakat* on behalf of depositors according to the same consent given by the depositors. The *Zakat* is due to the fact that the depositors are deemed fund-providers of Tabung Haji's investment activities.

Investment Management

The Tabung Haji manages its investment activities conforming to Shariah rules and processes akin to Islamic banks and other Shariah compliant investment companies. Tabung Haji governs its investment operations to ensure that they are Shariah compliant and do not contain any aspect which is contradictory to Shariah rules, by employing the services of the Religious Supervisory Council and the National Fatwa Committee to guide Tabung Haji on its investment transactions.

Tabung Haji has set up a specialised panel, the Finance Advisory Council, to guide the administration of Tabung Haji on investment operations, to ensure the viability of the investments. Panel members consist of distinguished business executives, bankers and senior government officials with expertise in the Malaysian economy. Tabung Haji's investments do not include anything that is contradictory to Islam such as banking, insurance, and hotels. Thus, Tabung Haji will not invest in businesses that are engaged with projects which are forbidden by Islam. Occasionally, when required, Tabung Haji will seek guidance from the Religious Supervisory Council in relation to any doubtful companies or potential investments. Tabung Haji continues running to the current day with considerable enhancements and varied projects, demonstrating that Islamic banking is called for as they can compete with highly formidable competitors in financial markets.

In 1990, Tabung Haji became the recipient of the Islamic Development Bank's prize in Islamic Banking in recognition for Tabung Haji's significant contribution in managing the funds of Muslims in Malaysia and successfully managing a large investment fund in a Shariah compliant manner. Its successful performance had enabled many individuals to fulfil their lifelong ambition to perform the *Hajj* in the Holy Land of Makkah. Tabung Haji has invented an effective system to inspire Muslims to save their money to cater for their expenditures during the performance of their *Hajj*.

Tabung Haji's achievements are in the ability to mobilise the small deposits in a dynamic way and invest these funds back into the economy in industrial sectors, retail, agriculture and real estate in compliance with Shariah. Tabung Haji not merely served individuals with Islamic services but channelled back the funds into the financial system via a vast stake in economy (IRTI, 2015). This particular bedrock of Islamic financial services in Malaysia shows that the government has chosen a courageous move to carry out an

Islamic option to the Muslim community. This bold move would enable the originally financially disadvantaged community to be given the chance towards enhancing their social standing and financial well-being. Tabung Haji is recognised as one of the prominent investment funds for Muslims as it gives highly competitive dividends to the depositors. After the successful creation of Tabung Haji, Malaysia's progress in Islamic finance remained stagnant for 20 years till 1983 when BIMB was set-up. The phase post-1983 witnessed a significantly rapid evolution in the landscape of Islamic banking and finance in Malaysia (Laldin, 2008).

3.7.2. Phase two (1983-1992): Development phase

The remarkable achievement of Tabung Haji had instigated many parties to advocate for the government to form a full fledge Islamic bank. Countless requests came from discussions and forums, which prompted the government to set up a national council of Islamic finance specialists in 1981 to research the plan of forming Islamic financial institutions in Malaysia. However, as a country with the majority Muslim population, the issues of Islamic banks in the Middle East had hindered their spirit. The first Islamic bank was set up in 1963, called Mit-Ghamr Saving House, located in the Mit Ghamr town of Egypt. Mit Ghamr town was located in the rural outskirts and mainly served the rural community, which consists of mainly pious Muslims. Naturally, the majority of people in Mit Ghamr did not place their savings into any bank because interest is banned in Islam and practically no banks were accessible to them. Under these circumstances, the task was not entirely to comply with the Islamic values concerning interest but also provide education on banking facilities to the rural population of Mit Ghamr. The Mit-Ghamr bank is a simple bank with 3 different types of accounts (Orhan, 2018):

i) Saving accounts - No interest was payable to depositors in the saving accounts, but they were allowed withdrawals on demand. They were also eligible for small, short-term interest-free loans for productive purposes.

ii) Investment accounts - the funds deposited in the investment accounts were subjected to restricted withdrawals and were invested on the basis of profit-sharing; and

iii) *Zakat* accounts or social services accounts - *Zakat* fund for redistribution amongst the poor.

The Islamic banking project of Mit-Ghamr had an unexpected success as saving deposits increased from 40,000 Egyptian pounds (EP) in 1964 to approximately 1 million EP in 1967 (Chachi, 2005). Although the Mit-Ghamr project made a good start, it was discontinued due to political and legal circumstances (Islahi, 2018).

However, in Malaysia, the demand for an Islamic bank increased and in 1981, the National Steering Committee composed of 20 Shariah experts performed an assessment on the proposal of a new Islamic bank in Malaysia examining various aspects of the plan. The positive assessment of the study had resulted in the incorporation of the first Islamic bank in July 1983.

The bank was injected with a small capital of RM80 million (approximately USD21 million), as the first step in formulating the Malaysia Islamic financial system (Nasser and Muhammed, 2013, pp. 82–83). The Committee tabled a report to the Cabinet in July 1982 and they approved the following proposals:

i) To set up an Islamic bank based on the rules of Shariah, the bank will be a limited company incorporated under the Company Act;

ii) To legislate an Islamic Banking Act for the supervision of the activities of Islamic banks and BNM shall be the regulating body; and

iii) To require the Islamic banks to establish its own Shariah Advisory Council to ensure compliance of its activities with the Shariah requirements.

Subsequent to the above proposals, the Cabinet enacted the Islamic Banking Act 1983 (IBA 1983) and consequently established the first Islamic Bank in Malaysia in 1983. The bank was named as Bank Islam Malaysia Berhad (Islamic Bank of Malaysia or BIMB) and was regulated by the IBA 1983.

BNM played a vital role in the advancement of the Islamic banking system in Malaysia. When the government created the above steering committee in planning the concept, BNM was tasked to draw up a report on the probability of initiating the first Islamic bank. It took BNM two years of arduous effort to set up BIMB, where BIMB was licensed to offer Shariah compliant banking business to the public. Since its inception in 1983 and up to 1999, BIMB was the one and only provider of Islamic banking services. This monopolistic right accorded to BIMB was to grant the bank the opportunity to build up their product range and test the market. It was also meant to safeguard the bank from strong competition with other more established and experienced conventional banks. (Ahmad Mokhtar et al, 2008). Over a period of 30 years, BIMB had expanded from its humble beginnings of 30 staff operating from a temporary office to a pristine headquarters which is now located in Kuala Lumpur's financial district with 133 branches nationwide and more than 4,000 employees. BIMB's initial total assets of RM325.5 million (USD85.6 million) in 1984 had multiplied to RM73.4 billion (USD19.3 billion) in 2018 (BIMB, 2018).

Takaful (Islamic Insurance)

The prevalent request of the Muslim society for an Islamic substitute to traditional insurance instigated the transformation of insurance industry in Malaysia. The first Islamic Insurance or *Takaful* corporation, Syarikat Takaful Malaysia was founded with an initial paid up capital of RM10 million (USD2.6 million) as a private limited company in November 1984 and later converted into a public limited company in October 1995 (Khan, 2016). It was also aimed to amalgamate into the Islamic banking structure in Malaysia. Due to the promising response for *takaful* products, a further three *takaful* companies were added to the industry from the period 1993 to 2003. Since then, the Malaysian financial structure scene had endured extensive architectural developments in the globalisation age, with various liberalisation procedures being initiated during the last decade. BNM had awarded five additional licenses in 2006 for companies to operate *takaful* activities in Malaysia. The licenses were extended to organisations or groups with sound financial standing and with extended capability in Islamic banking as well as the conventional insurance industry (Saad, 2012).

Takaful in Malaysia is legally defined as "a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants" (Malaysia, 1984, p. 6). This interpretation highlights the Islamic doctrine of *takaful* whereby a set of players consent to collectively secure one another against a particular cost or loss. Additionally, the Act defines *takaful* as a business "whose aims and operations do not involve any element which is not approved by the Shariah." As an Islamic insurance, conformity with Shariah guidelines and regulations is the pillar, as it is unquestionably the distinctive attribute that indicates the Islamic identification of *takaful* industry (BNM, 2007). The faith in the product is conditional on two principles– i) the activities of the organisation must totally observe with Shariah rules and ii), the worth and financial performance of the *takaful* companies is required to be revealed. Information on Shariah compliance is crucial in determining the purchasing decisions amongst the participants, enhancing their awareness of their doctrine, promoting clarity for strengthening governance, and safeguarding the Islamic status of *takaful* operators (Kasim, 2012).

Government Investment Certificates (GICs)

The GICs is Malaysia's Islamic treasury bill. Another component of Islamic banking is to complement BIMB was a Shariah compliant investment certificate proposed in 1983. These non interest-bearing certificates were issued to facilitate BIMB to satisfy its liquidity needs and works similarly as the existing Treasury Bills or Malaysia Government Securities i.e. they are essentially loans extended to government, the only difference is that GICs do not have a fixed dividend rate. The Ministry of Finance will determine the dividend rate when the GICs mature. It enabled BIMB to hold liquid assets and to provide as an investment channel for BIMB to briefly place its surplus funds.

The GICs are issued to the market under the Investment Act 1982 and are accessible to any other institutions in the financial system, apart from BIMB. The GICs is guided by the rule of *Qard-al-Hasan*, an Islamic principle which recognises the acquisition of these papers as a benevolent lending to the government. The certificates holders thus cannot demand any profits on their investment besides the principal sum, which will be entirely redeemed when the certificates mature. The dividends payments are solely at the government's discretion. GICs is the first government securities to be issued under Shariah principle (Khiyar 2012 p1137).

Initially, the GICs were being issued on a preliminary basis and their primary function was to facilitate BIMB in satisfying BNM's required liquidity requirement as Islamic banks were not allowed to hold any interest-bearing liquid assets. When the GICs achieved the attributes of complete financial instruments, Islamic banks demanded further GICs to comply with BNM's statutory liquidity requirement and for short term placement of their surplus liquid funds (Ahmed, 1997).

Labuan International Offshore Financial Centre (Labuan IOFC)

The Labuan IOFC was introduced on 1 October 1990 with the following purpose:

i) Strengthen Kuala Lumpur as Asia's Islamic financial hub;

ii) Support the improvement of the financial services segment to the GNP of Malaysia; and

iii) Promote the commercial expansion of Labuan and its surrounding regions

Another key factor is Labuan is the broad outlook of offshore financial businesses and commodities extended to regional customers. The range and standard of offshore financial transactions in Labuan have steadily risen over time and are bound to build up strength for improvement in the future. Consistent with the growth of conventional offshore banking, Labuan IOFC had broadened its base by directing its strength on turning into an International Islamic Finance hub. Labuan's new outlook came timely as Islamic banking had assumed a progressively prominent role in the international landscape. The rise in revenue of Muslim regions, particularly in the Middle East, together with a new awareness of Islamic understanding, had boost a great interest for Islamic financial products. Labuan offers an offshore banking system that met the needs of foreign investors, which is of tax efficiency and proper regulation.

Labuan is strategically located to reach out to Muslim investors in the Southeast Asia region as well as Middle East investors seeking for opportunities to invest in Islamic financial products. Consultancy and advisory services are offered by specialist Islamic consultants and management firms to offshore investors that intend to trade in Islamic products. Islamic financiers have to adjust to meet the needs of the global market and develop Labuan into a hub with a niche in offshore Islamic banking is a sensible extension of the evolution of Islamic financial framework in the Malaysian domestic market (Khiyar, 2012). The need for cross-border Islamic project financing were rising quickly due to the rapid growth of wide scale infrastructure projects in developing countries.

These are the high prospect domains for Islamic banking players in Labuan to maximise the promotion of Islamic financial products consistent with the practical requirement of modern day customers (Khiyar, 2012, p. 1113).

3.7.3. Phase Three (1993 - 2002): Take-off Phase

This is the period where the essential components of a comprehensive Islamic Banking Framework were established. Malaysia has grown more confident in the growth of its Islamic banking system and had a strong notion to be one of the leading global players in the industry and this required the enhancement of the Islamic financial system in a limited span of time. In order to have an Islamic financial system, Malaysia needed more financial institutions in the region as one bank could not suffice. At this point, BNM was expected by the public to set-up a comprehensive and robust Islamic banking framework that runs parallel with the conventional banking system for all Malaysians. In 1993, BNM initiated a steady and piecemeal strategy by introducing an 'interest-free banking scheme' to the traditional banks, later known as 'Islamic windows'. This scheme allows conventional banks to provide similar Shariah compliant products as Islamic banks by using their existing infrastructure (Ahmad Mokhtar, Abdullah and Alhabshi, 2008). It had resulted in 12 local and 3 foreign commercial banks with Islamic windows. (Nasser and Muhammed, 2013).

The former Governor of BNM (1999a) explained that the distinction between the Islamic and the traditional financial structures are those of ideology and virtues. The Islamic financial framework is based on Islamic fundamentals and wisdom and forms an essential part of Islam. On the contrary, the traditional financial system is based on capitalism which segregates between religion from financial matters in daily activities. In capitalism, it gives an entity absolute ownership of their property and forms decisions based on profit. This convention is based on the personal interest and right (IRTI, 1995, p. 13). Five years onwards, in 1998, banks with Islamic windows were then requested to replace their Islamic units to a proper banking division under an improved scheme called the 'Islamic Banking Scheme' or *Skim Perbankan Islam* (BNM, 1998a).

In the same year, Malaysians also witnessed the establishment of a second Islamic bank, Bank Muamalat Malaysia Berhad (BMMB). This resulted from a policy response to the

Panic of 1997, with the formation of BMMB due to a merger deal between 2 major banks[36]. The deal concluded that the Islamic banking assets and activities of these two banks were carved out and transferred to a newly established bank i.e. BMMB. It was also anticipated for BMMB to be a healthy competitor to BIMB and to end the continuous criticism from the media for BIMB's overly prudent approach and red tapes (Ahmad Mokhtar, Abdullah and Alhabshi, 2008). The Malaysian government had always linked its economic and social policy to the progress of Malaysia's Islamic banking framework. The Islamic banking framework is expected to rise the social standing of Muslims and narrow the economic gap between the different ethnic groups. Given this, the development of Malaysia's Islamic banking framework received full support from the country's leadership and the corresponding government agencies (Khiyar, 2012).

An Islamic Interbank Market

Correspondingly, by the end of 1993, equipped with adequate support by the government, the Islamic banking framework had accomplished two of its targeted milestones in achieving its ultimate goal for a complete Islamic banking framework. The unaccomplished target was the establishment of a short-term Islamic interbank market which allows for Islamic financial institutions to borrow and lend money at interbank rates and following the Shariah rules. An Islamic money market was enforced in the Malaysian financial system on 3 January 1994 and was the first in the world (Bank Negara Malaysia, 1994). The Islamic inter-bank money market comprised the following features (Khiyar, 2012): Inter-bank trading in Islamic products; Inter-bank Islamic investments; and Islamic inter-bank cheque clearing system[37].

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[36] As a response to the Panic of 1997, the NEAC and BNM launched the consolidation of the financial institutions, where Bank Bumiputra Malaysia Berhad (BBMB) and Bank of Commerce Malaysia Berhad (BOCB) were merged.

[37] A clearing system was introduced at Bank Negara for "Bank Islam Malaysia and the SPTF (Skim Perbankan Tanpa Feadah, translated to English, Interest-free Banking Scheme) units of the commercial banks. Cheques with respect to these institutions will be segregated from the conventional cheques for clearing purposes from January 3, 1994. The Islamic inter-bank cheque clearing system is also based on the principle of Mudharabah. At 12:00 midnight, during the automatic cheque clearing at BNM, SPTF banks (including Bank Islam Malaysia) having a deficit will automatically be funded from the surplus funds of other SPTF banks on the basis of the concept of Mudharabah. If there is still a deficit after such funding, it will be funded by BNM on the same principle; i.e., Mudharabah. The profit ratio for this mechanism is 70:30 (70% for the investor). The repayment will be effected from the next morning" (Khiyar, 2012, p. 1142).

Malaysia had turned up to be a central hub of Islamic banking and finance in Southeast Asia, evident by its continuous expansion from a basic pilgrim's fund to a full-fledged financial system. Since the launch of the BIMB in Malaysia in 1983, Malaysia had progressively moved toward the incorporation of an effective and more robust Islamic financial system, operating alongside with the conventional system. BNM had set-up the internal Shariah Advisory Council (SAC) for Islamic Banking and *Takaful* on 1 May 1997 as the highest Shariah authority as part of an effort to assimilate and harmonise the Shariah interpretations among banks and takaful companies. The goal of the SAC is to function as the sole government agency to inform BNM on Islamic financial institutions' operations. This includes all Islamic banks, *Takaful* companies and banks with Islamic banking windows. Its tasks also include coordination of Shariah matters and assessment of new Islamic financial products. BNM via the SAC will from time to time issue guidelines and circulars in relation to Islamic banking and finance. All financial institutions operating in Malaysia must be informed and strictly be in conformity with these guidelines as BNM is bestowed with the special powers to supervise financial markets under the Bank Negara Ordinance.

3.7.4. Phase Four (post- 2004): The liberalisation of Islamic banks

During the early 2000s, practically all Malaysian financial institutions had set-up separate Islamic units, and almost all investment banks had set-up their Islamic capital markets departments. Initially there were only two full fledged Islamic Banks, the first being BIMB and the second was BMMB. On 1 January 2008, the Islamic banking activities of Maybank began to operate as a new subsidiary of Maybank now known as Maybank Islamic Berhad. The first to be set up, BIMB operates through 86 offices in the country whilst the more later formed BMMB has 46 branches. In addition to the Islamic banks, there are further thirteen commercial banks that offer products and services under the Islamic banking arrangement.

Presently, Malaysia is deemed to have one of the most developed Islamic financial frameworks in the world. Apart from the 'Interest-free Banking Scheme', Malaysia had developed an Islamic debt securities market in 1990, operated an Islamic equity markets since 1995 and established an Islamic Interbank Money Market in 1994 (Bacha, 1998). The Islamic banking industry liberalisation strategy saw 3 new Islamic banks emerging from the Gulf countries (BNM, 2004). The plan was to bring further competition and to open fresh opportunities to further enhanced Malaysia's banking industry's performance.

3.8 Conclusion

There has never been a true Islamic community in Malaysia although Islam was already in existence since pre-colonial eras. The concept of Shariah in theory and practice in Malaysia has constantly been inconsistent. During the colonial rule, the Residential System was introduced, and it marked the birth of a secular system which removed religion from the state. The Shariah law practiced prior to the colonial intervention became an entirely personal and family law and did not have any influence on the state administration. The modern "English law was used as the law of general application in all non-religious aspects of life and was portrayed as the only system capable of effecting change and economic development" (Yasin, 1994).

After independence, especially during the Mahathir administration, the Shariah was expanded to economic and finance and used as a tool for economic development, while maintaining the adapted English legal system. For instance, under the Malaysian taxation, the *Zakat* paid on income is an allowable deduction against the tax payable. This was to encourage Muslims to pay *Zakat* and avoid double tax payments. It intends to demonstrate that Shariah law and Islam is a reasonable religion capable of adapting to change. It is an undertaking to strengthen the perception of Shariah law as a policy, similar to its position during the pre-colonial days.

CHAPTER 4: THE NEW ECONOMIC POLICY (NEP)

> "It is fundamental to remember that the rights accorded to any minority or other non-powerful group in any state depend on the ideal of those in power. A state may be democratic in form but unless it is democratic also in ideal, unless the majority of its citizens are actively loyal to the transcendent principles of democracy, recognizing the ideal validity of every man's status as a man, then the arithmetic minority has, through the democratic form, no rights at all... If Muslims do in fact treat non-Muslims unjustly then a democratic framework would merely give them as a majority the constitutional authority for doing so without let or hindrance."
>
> Wilfred Cantwell Smith

4. Introduction

Malaysia's policy responses to the 1997 Panic were unique due to its unorthodox approach as compared to the neighbouring countries that had suffered the same contagion effect. The NEP is understood to be an important factor that affected the policymaker's decision-making process, especially in response to the Panic of 1997. Therefore, this chapter examines the reasons behind the establishment of the NEP and its significance to the Malaysian people. The first half of this chapter gives the essential background in understanding the social and political landscape in Malaysia. It analyses Malaysia's social structure preceding the NEP and the important historical events that compelled the ruling government at that time to establish an affirmative action policy such as the NEP.

The second part of this chapter is the process of legitimisation and implementation of the NEP throughout different phases of Malaysia's 5-Year Plan[38]. It goes further to analyse the importance of the NEP to the extent that the Malaysian government had decided to uphold such a policy at the expense of foregoing financial assistance from the IMF.

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[38] The Malaysia 5 Year Plan is a comprehensive outline of government development policies and strategies. The first plan was introduced in 1965, covering the development agenda from 1966 to 1970. Currently Malaysia is at the verge of introducing its twelfth plan (2021-2025) as defined by the Economic Planning Unit, Malaysia (https://www.epu.gov.my/en).

Malaysia took the risk of going against the current, while its neighbours accepted the much-needed fund from IMF.

The NEP is an affirmative action policy that was created as a response to a violent ethnic riot that took place on 13 May 1969. This ethnic riot or better known to the older generation of Malaysians as the "13th May Incident or *Peristiwa 13 Mei"*, was recorded as one black spot which cannot be wiped out from Malaysian history. Until today it is considered a taboo and the most sensitive issue to be discussed in public (Liaw and Moiden, 2017). The 13th May Incident convinced the government that the struggle for ethnic harmony could only be achieved by reforming the nation's economy and society. The government launched the NEP in 1971 with two broad goals: eradicate poverty, regardless of race, and restructure society so that no ethnic group could be identified with a specific set of jobs[39]. An Outline Prospective Plan for the period 1970-90 was announced in early 1970 for the implementation of the NEP. The broad objective of the 20-year programme was to launch Malays who make up slightly more than half the Malaysian population into the mainstream of Malaysia's economic life (Hiebert and Jaysankaran, 1999).

4.1 Malaysia's social structure

Malaysia is situated in Southeast Asia, a country separated into two regions i.e. Peninsular Malaysia and East Malaysia. Peninsular Malaysia is made up of 11 states and the Federal Territory of Kuala Lumpur and is separated from East Malaysia by the South China Sea. East Malaysia comprises two states, Sabah and Sarawak which are located on the northern part of the island of Borneo. Malaysia is an ethnically heterogeneous country, with a total population of 32.6 million, of which 25.9 million is in Peninsular Malaysia, 2.8 million of the population is in Sarawak and 3.9 million in Sabah (Malaysia, 2019). The Department of Statistics Malaysia (2019) reported an estimated ethnic composition of

[39] The British policy of "Divide and Conquer" had resulted in the three major ethnic groups to be identified by geographical location and occupation. In addition to the British legacy, the Japanese military occupation (1941-1945) fostered communal distrust and saw several smaller ethnic clashes.

Malaysia's population as 69.3% *Bumiputera*[40], 22.8% Chinese, 6.9% Indians and 1% of other ethnic background. The *Bumiputera* ethnic group consists of Malays and other smaller ethnic groups found in Sabah and Sarawak. These two Borneo states are also less developed than the Peninsular states due to their hostile geographical conditions hindering much of economic development. The island of Borneo has vast areas of swamplands, impenetrable tropical rainforests and mountainous topography, with towns and villages mostly linked by rivers and streams.

Malaysia has undergone significant economic improvement since independence in 1957, with GNI per capita in constant 2010 prices rising from USD1,290 in 1960 to USD6,445 in 1996 (World Bank, 2020). However, the swift development enjoyed has not been without its drawbacks. Despite reasonably stable economic growth and low inflation for over a decade after Independence, income inequalities increased and poverty remained widespread. The ethnic Malays stayed disproportionately poor and were largely found in low-productivity peasant agricultural and the public sector, outside the modern, urban and corporate domain (Table 4.1).

Table 4.1: Ethnic composition of employment by industry in 1970

Industry (Peninsular Malaysia)	Malay (%)	Chinese (%)	Indian (%) and other ethnic*
Agriculture, Forestry & Fishing	68	21	11
Mining	25	66	9
Manufacturing	29	65	6
Construction	22	72	6
Utilities	48	18	34
Transport and Communication	43	40	17
Commerce	24	65	11
Services	49	36	15

Note*: Other ethnic group makes up less than 1% of the composition.
Source: Snodgrass 1980 as adapted in Gomez and Jomo (1999).

[40] The term *bumiputera* does not refer to one ethnic group but refers to Malays and other indigenous people. In today's Malaysia, the *bumiputera* segment of Malaysian society consists of dominantly Malay Muslims, but also includes those non-Malay ethnic groups in Sarawak and Sabah (Kok-Wah Loh, 2000, p. 65)

The British's pursuit of economic interest and strategy had placed or rather displaced most of the *Bumiputera*s[41] in rural areas, while the minority Chinese and Indians are located in urban areas, a severe regional imbalance which had intensified further the political-economic dichotomy while the political sphere were monopolised by the elite *Bumiputera*s. The political "urgency of the inequality problem is not because overall income distribution is exceptionally skewed but because the inequalities reflect deep ethnic divisions within the Malaysian society" (Hashim, 1995). Furthermore, regional inequalities still existed, and certain states are generally populated by one ethnic group, exacerbates the circumstances. The assumption is that there is a distinct link between ethnicity and poverty.

Malaysia is not spared from confronting with spatial income inequalities and its policymakers were compelled to correspond to the challenges of income imbalances within their perimeters, which goes beyond the issue of industrial policies or trade strategies. Due to its British colonial heritage, the communities were divided through geographical location and occupation. The south-western peninsula was centred on entrepot market and the tin and rubber industry, whilst the north eastern peninsula were focused on fishing and agriculture. The western coastline and southern peninsular, populated by the minority Chinese that were originally brought over by British as tin-miners, had relatively large urban towns which boasted developed public services and enjoyed the benefits of modern projects such as financial services and manufacturing. Consequently, the west coast of the peninsular was developed into a higher income society surrounded with more developed infrastructure. In contrast, rural areas, vastly populated by the native Malay, relied on traditional and less profitable economic projects and therefore generally lack the same standard of facilities (Jomo, 2004b).

This structural social inequality was exemplified in the social barometers of well-being such as per capita income and education level. This inequality was overlain with an ethnical dimension as distinct immigration rules were relevant to specific areas of the country. When the Malaysian Federation was formed via the consolidation of East

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[41] Bumiputera refers to the indigenous of Malaysia, mainly the Malays of Peninsular Malaysia. Non-Bumiputeras refer to those not considered indigenous to Malaysia, mainly referring to ethnic Chinese and Indians.

Malaysia (Northern Borneo) with the Peninsular states, the situation was further accentuated (Hutchinson, 2017). Apart from the inherent intricacy of these conundrums, Malaysia had also transformed over time. Its economy had become progressively based on industrial and services, general levels of income have increased, and its populace has turned out to be further urbanised. Given this, policy responses had also progressed, considering different interpretations of the correlation between economic interest and topography, whilst concurrently searching the best approach in lowering domestic income inequalities (Hutchinson, 2017).

4.2 The NEP

As a multi-ethnic nation, Malaysia needs to radically lessen the poverty incidence and lower the income inequality among its population while attaining swift economic development and preserving ethnic unity. The period between 1970-2000 was complicated and challenging, that required a virtuoso approach by the government to cater to the wide-ranging requirements of a heterogeneous population.

The policy decision-makers created a series of policies which gave guidance to the government officials for the national development during 1970-2000. The two fundamental policies were the NEP (1970-1990) and the National Development Policy (1991-2000), which saw national harmony as the aspiration for economic progress and their key components shaped the yardstick for all supplementary policies and strategies. Mahathir's *Vision 2020* formulated in 1991 complemented these policies and outlined an overview of Malaysia's development for the next 30 years (World Bank, 2004). Additionally, there was the NERP passed by the Malaysian cabinet in 1998 - a special policy response to deal with an uncharacteristic economic condition that Malaysia confronted due to the Panic of 1997. The policy reponses under NERP shall be critically analysed in the next 2 chapters.

4.2.1. Prologue to the NEP

Throughout the 1960s, economic progress evidently intensified income inequalities in Peninsular Malaysia, particularly the income disparities within each main ethnic group. Distribution of income in Peninsular Malaysia actually deteriorated during the period

1957-1970, in all ethnicity notably among the Muslim Malays. While the majority of Chinese and Indians formed the largest part of the working class, the mainstream Malays comprised mainly farmers.

The governing Alliance coalition[42] in the 1960s was principally an alliance of ethnic-based political parties headed by UMNO. In essence, racialism political doctrines met with minor competition. As a result, the worsening socio-economic condition and ethical scene in the 1960s were interpreted predominantly in ethnic terms. Even though post independence, the economy was largely controlled by non-domestic shareholders, many ethnic Malays were of the view that ethnic Chinese economic domination had caused the underdevelopment of the Malay economy. On the contrary, many non-*Bumiputera* considered the UMNO-led Alliance ruling administration to be accountable for official state prejudice towards them. The majority of business communities were Chinese, while most state officers were *Bumiputera*. Hence, only the elite *Bumiputera* political group together with the wealthy Chinese entrepreneurs benefited the most from the economic development in the 1960s.

During the May 1969 general election[43], the governing Alliance coalition managed to secure a lower majority in the parliament in spite of winning no more than “50% of the vote with the aid of gerrymandered constituency and delineations” (Jomo, 2004b). A fraction of the *Bumiputera* and the bulk of non-*Bumiputera* voted for the opposition (Gomez and Jomo, 1999). Pressure had already been building up before the general elections due to disappointments insinuating the inherent ethnic relationships. After the elections, riots erupted seemingly due to socially aggressive actions by supporters from the winning opposition party. The ethnic riots were initiated in the national capital of Kuala Lumpur and was understood to be stage-managed by certain politicians. The situation was aggravated by the armed demonstration by young cohorts of an incumbent minister who had lost his seat in the state assembly.

[42] The coalition consists of the Alliance (1954-74) and Barisan Nasional (1974- 2018).

[43] The third general election since independence in 1957.

After the unfavourable election fallouts and the consequent riots, the incumbent prime minister Tunku[44] was forced to resign and was replaced by his deputy, Razak, who was second-in-command of the ruling coalition. It was understood that he had "orchestrated a 'palace coup'—with the stronger military police function in response to the ethnic riots—to win over the leadership from Tunku" (Jomo, 2004b). Thus, the "transformation of UMNO leadership also revealed the dominance and insurgence of 'Young Turks' within UMNO who had contested Tunku's leadership" since the late 1960s (Gomez and Jomo, 1999).

After the grim 13th May Incident, UMNO's domination over the Alliance coalition became more prominent as it managed to co-opt the opposition parties. Although they were mostly established on ethnicity, dissimilar from the parties in the Alliance coalition, they were organised less openly along ethnic boundaries. It is commonly recognised that Malaysian economic policy had changed radically as a chain reaction to the ethnic uprisings and the UMNO's palace coup connected with the 13th May Incident (Jomo, 1990).

The overview on the background of the origination of the NEP is divided into two historical periods, (1) the period before independence when Malaysia was under Colonial Rule between 1786 until 1957 and (2), the period after independence between 1957 until 1969.

4.2.2. The Colonial Rule (1786-1957)

The British colonisation of Malaya (1786-1957) had shaped the unique characteristics of the multi-ethnic society in Malaysia. The economic legacy inherited from the colonial era had ended in a clear partition of ethnic groups based on commercial activity, geographical area and political behaviour. The colonial Malayan economy grew around the global trade in tin and rubber, which was controlled by the British and to a lesser extent the Chinese (Hirschman and Suan-Pow, 1979).

[44] Tunku was the first Prime Minister of Malaysia after its independence in 1957 and led the ruling coalition party.

When the Sultan of Kedah[45] leased Penang to the East India Company (EIC) in 1786, it recorded Britain's first footing in Malaya soil. But colonial control only began in 1874, when the Sultan of Perak[46] signed the "*Perjanjian Pangkor* or Pangkor Agreement", under which a British 'Resident'[47] was appointed as an advisor, but his advice "must be sought and acted upon on all matters other than those involving the Malay religion and custom" (Tarling, 1962). The EIC's interest was in the tin industry and this had driven them to force control over the neighbouring states. They built railroads connecting the minefields to the ports in Selangor and Perak and eventually to states along the coastline of west Peninsular Malaysia. Other industries such as rubber plantations also flourished because of the good transportation network.

While the British were aware and recognised the Malay's special rights as the native inhabitants of Malaya, economic advancement and the social wellbeing of the Malays were not their priority. The colonial policy was in fact to preserve the Malays in their familiar and traditional surroundings while the region developed (Smith, 1995). Since the British held a particular legal liaison with the Malay aristocracy, they had preferred that the prevailing social structure among the Malays be maintained. Hence, the British continued to pursue their commercial endeavours while minimising disruption to the society. However, the rising need for labour had led the British to import the workforce from mainland China and India. Chinese workers were for the tin mines and Indians were for the plantations and estates.

The effects of these British policies were deep reaching on the ethnic architecture of Malaysia, notably on the link between jobs and ethnicity. Noh (2012) revealed that the British government had constantly passed short-term rational decisions that spurred the advancement of two autonomous races, Malays and Chinese. The British resolution to safeguard Malay *de jure* sovereignty while integrating a Chinese commercial existence formed two divergent communities that increasingly fought for access to both political

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[45] Kedah is a state north of the Peninsular and historically Penang Island formed part of its territory.

[46] Perak was a state known for its tin mining on the west coast of the Malay Peninsular. Perak has land borders with the Malaysian states of Kedah to the north and Penang to the northwest.

[47] A British Resident is an officer from the British government placed as the adviser and administrator in Malaya.

and commercial resources. However, by 1957 when Malaya gained its independence it was imminent for them to enter on some type of consociational arrangement (Noh, 2012).

In exploiting Malaya's low-cost resources, the British government did not take into account the path susceptible to the nature of policy decisions and any long-term repercussions. It had produced in the present-day recognition of ethnicity with economic enterprise and geographical area. After achieving independence, there was a divergence between commercial and political hegemony of two major classes, one comprising the Malay political elites and bureaucrats who enjoyed political prestige but lacked any commercial base and financial backing, whilst the other were the Chinese entrepreneurs who had a commercial base but lacked the necessary political clout (Hashim, 1995).

As mentioned earlier, the education policy under the colonial rule did not benefit the rural populace which consisted of the majority Malay and Indian descendants. State funded secondary schools and tertiary education were only accessible in the urban areas and used English as a medium of instruction, while education for the Malay was channelled towards fishing and farming.

4.2.3. Post-Colonial Development (1957-1969)

Following independence, the new regime introduced a development program specifically designed for significant economic expansion while maintaining a predominantly laissez-faire economic strategy. They carried out strong attempts to enhance the export sector by promoting new essential commodities and the manufacturing industry while broadening the existing tin and rubber industries. The newly independent Malaysia then identified economic progress as the advancement of the contemporary urban region. The modern region, manufacturing goods and services were thought to draw a stream of people from traditional rural territories.

However, the improvement in the economy also came with its challenges as the government's pledge to a laissez-faire policy with minimal direct state interference favoured the more traditional business considerations, which merged and further reinforced the Chinese entrepreneurs. Even though the Malays led the government and they had sought to promote the improvement of the Malay entrepreneur group, the growth was not as anticipated and was relatively low (Hashim, 1994). The government's effort, 10 years post-independence only saw a slight improvement in the Malay's participation in the economy, which was measured by the share ownership in publicly listed companies i.e. only 1.9% share-holdings as compared to 22.5% and 86.7% holding the Chinese and foreigners, respectively (Malaysia 1973: 83). Real household incomes for the lower income group for all races had declined by 13% after independence up to 1970.

Hashim (1995) discovered that the income disparity between the common Malay and Chinese households was growing, which brought about the notion that any gains of progress were being unequally distributed. The Malays initially believed that Independence would mean a restoration of their appropriate place in Malaysia's socio-economic order. However, when their assumptions remained unrealised as the economy prospered, the Malays began developing a strong objection to government policies. On the other hand, the non-Malays were starting to resist any government efforts to promote Malay political domination and economic interest. Additionally, the less privileged non-Malays attributed the decrease of their economic stand on state policies that favour the Malays.

The rising hostility and antagonistic views increased ethnic polarisation during the weeks preceding the general election in 1969. The increased uneasiness and cynicism of the Malays towards the wealthier Chinese climaxed in the violent ethnic riot of 13 May 1969. The supposedly congenial coexistence of multi-ethnic community was merely masking the now deeply rooted communal cleavages (Hashim, 1995).

4.2.4. Legitimising the NEP

The policymakers were aware of the growing tension and the presence of the Chinese and Malay polarisation during the planning stage of the NEP, but trusted that economic expansion could iron out the issue of inter-ethnic resentment. Accordingly, they did not dedicate concern to the issue of disparity. However, the divergence between prosperity and poverty had been widened and finally steered to the Malay infuriation in the shape of post-election ethnic riot in 1969 (Milne, 1976). The NEP was implemented after the 1969 riot, which was triggered by the extent of poverty and widening income between two dominant races.

The NEP was believed to be one of the steps chosen by the authority to meet the intentions of national unification, and to enhance the relative livelihood of Malays, thus anticipating to ward off similar potential outbursts of disturbance. Milne (1976)'s analysis on the NEP was not only were its foundations political, but it also had overwhelming political ramifications. Its formulation, its implementation and the way in which various ethnic groups perceived it, all expressed themselves in political forms (Milne, 1976). The NEP had a two-pronged objective of "eliminating poverty and restructuring society to ensure economic and social fairness for the less fortunate ethnic community in Malaysia" (Rasiah and Shari, 2001). It has been claimed that the NEP is based on one of the most essential principles of fairness, and its implementation had set the foundation for a modern Malaysian society for all races (Pramanik, 2002).

i) The NEP was drawn to cover a twenty-year outlook for the period of 1971-90 and subdivided into smaller four detailed 5-year Malaysian Plans:
ii) The Second Malaysian Plan (1971-1975)
iii) The Third Malaysian Plan (1976-80)
iv) The Fourth Malaysian Plan (1981-1985)
v) The Fifth Malaysian Plan (1986-90)

4.2.5. The Second Malaysian Plan ("2MP")

The 2MP saw the beginning of the NEP with an overriding objective of national unity, a result of the government's dramatic response to the 1969 ethnic riot (Malaysia, 1971; Lim, 1986). The 2MP's poverty eradication programme was to increase the access for the poor to property, capital and education as well as other public facilities. The focus of 2MP was to find the most effective way of reducing the occurrence of absolute poverty, unlike the previous First Malaysia Plan (1965-1970) which had ignored this and was only designed to promote economic expansion via focusing on the import-substitution trades and export (Malaysia, 1970; Md. Mansur, 2000). The 2MP was drafted as the first program in the sequence of the NEP series and accorded utmost importance to a more even dissemination of income and affluence among the public (Malaysia, 1971; Lim, 1986). The 2MP as the introduction to the NEP was intended to accomplish the target via a "two-pronged" methodology:

i) The first prong was aimed at curtailing and ultimately ensuring that Malaysians, regardless of ethnic group, be free of poverty;

ii) The second prong was aimed at accelerating the process of restructuring Malaysian society to correct economic imbalance, to reduce and eventually eliminate the identification of race with economic function”\. (Malaysia, 1971).

This process required the rejuvenation of rural communities, a swift and improvement of urban projects and at all stages of the processes, so that *Bumiputera* communities would turn into full participants in all facets of the monetary activity of the country. The NEP was centred on a rapidly growing economy, and that in the execution of the strategy "the Government will assure that no specific group will encounter any loss or suffer any sense of destitution" (Malaysia, 1971). In the application of the 2MP, the Malaysian government chose to be more forceful and led the project in lessening the economic gap between the *Bumiputera* and the non-*Bumiputera*, as opposed to the laissez-faire attitude of neo-liberalism pre-1970. Foreign trade policies were designed to regulate wholly owned foreign entities and to promote joint venture projects with local associates, but the government made considerable attempts to draw further foreign investment to fund the construction industries (Athukorala, 1998).

Legal provisions have been modified and many contemporary businesses have been created during the 2MP period. The Investment Incentive Act (1968) stated that the NEP guidelines for the supervision of offshore finance were given solely to companies having pioneer status, which produced complications in reaching desired ownership quota and employment objectives of the NEP (World Bank, 2004). This was because the guidelines covered only a limited fraction of companies engaging in business in Malaysia, merely about 10% of the total. In 1971, this Act was modified to urge *Bumiputera*’s involvement in other sectors than agriculture, such as manufacturing or business (World Bank, 2017c). In addition, institutions were established or restructured to either inspect or enforce implementation of the NEP (Md. Mansur, 2000).

4.2.6. The Third Malaysian Plan (“3MP”)

The 3MP was the second 5-year plan in the series of the NEP and its primary aims were to continue with the initial objectives of NEP, i.e. to lessen the prevalence of poverty and to streamline society via economic growth instead of redistributive approach. The difference between 2MP and 3MP is that under 3MP, the private sector especially with exports and corporate investment was expected to boost the economic growth, while the 2MP relied on public expenditure and investment for the economic growth (Malaysia, 1976; Lim, 1986).

4.2.7. The Fourth Malaysian Plan ("4MP")

The 4MP was a continuation of the 2MP and 3MP, but the plan was concentrated to the expansion of heavy industry to utilise Malaysia's natural gas. Since capital investment in heavy industries required substantial amount of funds over a long gestation phase, the government set-up a public-owned company, the Heavy Industry Corporation of Malaysia (HICOM) to direct public funds into these projects, as domestic private funds were unable to manage these ventures (Malaysia, 1981). Since Malaysia was faced with low economic growth during the early 1980s due to the global recession, public sector spending was restrained and the Industrial Coordination Act (ICA 1984) was amended in 1984 to relax the prevailing economic policies. The amended ICA 1984 permitted foreign investors 30% equity ownership and up to 80 % if they export a minimum 20% of their manufactured products (Gomez and Jomo, 1999).

4.3 The Fifth Malaysia Plan ("5MP")

The 5MP was mainly on preserving the general objectives, whilst giving emphasis to the industrial sector. The 5MP was to improve investment by providing incentives for investment in tourism, manufacturing and agriculture (Malaysia, 1986). Consequently, the Incentives Act (1971) was repealed and superseded by a new act in 1986. Under the improved Promotion of Investment Act (PIA 1986), pioneer status companies were allowed a 5-year tax holiday, regardless of the investment stage (Malaysia, 1986). Additionally, the pioneer status length was stretched to 10 years on a case-by-case basis (Md. Mansur, 2000).

4.4 Legacies of the NEP

The NEP's core foundation was to balance the scale between economic development and nationwide acceptance. The Panic of 1997 had caused the policy decision-makers to critically reassess Mahathir's economic policy structure as the NEP's core objectives were still the main aspiration surrounding the policy responses (Lee, 2004). NEP's core objectives were to lessen the wealth inequality among the 3 major ethnic groups, i.e. the *Bumiputera*, Chinese and Indian, with the underprivileged majority *Bumiputera* given special attention. However, during the early days of implementation of the NEP, its legitimacy was hardly questioned due to the political and social repercussions, even when some NEP processes had adversely effects to the economic progress (Milne, 1976). Mahathir had also launched the 'Look East' policy to emulate the work culture and economic progress of the East Asian countries, especially Japan and Korea, countries which were more similar to Malaysia in terms of social and political welfare as compared to the Western European nations.

In 1985, Malaysia was hit by a recession with a soft 10% contraction and continued for one year. However, it was deepened by the declining export products, particularly tin, rubber, petroleum and palm oil. Hence, there was restricted scope for monetary development because the government had excessively invested in heavy industrial ventures via its public-owned HICOM. Consequently, the Mahathir administration changed its efforts to attract non-*Bumiputera* and foreign investors. Two liberal policies were introduced to encourage investment from overseas investors via the PIA 1986 and the ICA 1984 was amended to support funds from non-*Bumiputera* investors. These policies eased the restrictions on employment terms and ownership that were initially intended to support the *Bumiputera*'s stake in the economy, especially in the manufacturing sector (Jomo, 2003).

Even though the Malaysian government had gradually embarked into more liberal polices akin to the Washington consensus but the government still did not abandon the NEP. Therefore, it is reasonable to suggest that Mahathir instigated these policies not to revamp the NEP framework but to withstand the economic recession. Given this, it is rational to imply that his policy modification were pragmatic and a not directly influenced by neoliberalism (Rasiah and Shari, 2001).

Snodgrass (1995) noted in his work that liberalisation was a reaction to overcome the short-term setback of the recession in 1986, but due to its success the liberal policies morphed into the basis for a lengthened development strategy. Although Mahathir was a prominent advocate of hard work, better efficiency, and resourcefulness while condemning grants, he is barely a coherent free market economist. He is more resonant of President Roosevelt, elected to office in the Depression and pitching about pragmatically to find a possible remedy (Snodgrass, 1995).

One of NEP's initial manifesto was to scale back uneconomical public companies to reduce the cost of public funding. This goal was not entirely achieved. The principal cause was that the deregulation and industry-oriented restructurings try to avoid from intruding on *Bumiputera's* interest in the market. Quite the opposite, a key requirement for privatisation exercises was that they must correspond to NEP purposes i.e. the *Bumiputera's* economic well-being should be improved in the development (Jomo, 2004b). In fact, during the period of privatisation (1986-1989) 8 mega projects were awarded to *Bumiputera* entrepreneurs and ironically, the policy offered the commercial and monetary foundation for cronyism, as prominent *Bumiputera* policymakers awarded government deals to their protégés (Gomez and Jomo, 1999).

4.5 Liberalisation of Malaysian policies

When Mahathir was elected to office in 1981, he vouched that the government was to sponsor developments of a heavy industrial segment, but was shortly confronted with the global economy downturn. Even challenged by escalating economic difficulty, Mahathir persevered in his effort to create the national car (Proton car), steel (Perwaja Steel) and cement (Perak-Hanjong Cement) companies. For the period between 1981 to 1984, Malaysia ran a hefty budget and caused a deficit in its balance of payments, with the anticipation that the global commodity prices would rise and rectify the situation.

However, the anticipated price rise did not occur and overdue fiscal adjustments were made and regulations overseeing private investments were relaxed in 1986. This liberalisation act had exempted various companies from the required local ownership and other affirmative action obligations, which was initially imposed by the NEP. The liberalisation drew billions of dollars of financing into Malaysia with substantial capital inflows from the Northeast to Southeast Asia stimulated by a rise in wage and exchange rate realignments. Since 1987, economic growth had been near 9% per annum, leading to yet unfamiliar prosperity, full employment[48], and considerable immigration from bordering countries (Snodgrass, 1995; Farooqi, 2010).

Gradually in the early 1990s, liberal politicians had undertaken more liberal policies and although there was no visible demarcation of a policy swing, they incorporated some characteristics of neoliberalism whether explicitly or implicitly. Two core policies, being extensions of the NEP i.e. the National Development Policy and Mahathir's Vision 2020 had outlined nine tasks to be dealt by the government before Malaysia can achieve its goal of becoming a developed nation by 2020. Three of these tasks were akin to neo-liberalisation-with-industrialization as it's a paradigm shift from a fading Keynesian developmentalism and an emergent Washington Consensus.

Due to political reasons, from time to time Mahathir adopts non-liberal policies such as control on capital, despite being challenged by the more liberal policy makers at the MoF and BNM. The slight shift in the direction towards neoliberal economic concepts were both driven by political deliberations and economic motivations (Lee, 2004). Even though *Bumiputera* entrepreneurs were safeguarded and financially supported by the NEP, some criticised that the support and grants were still inadequate to achieve the primary objective of 30% stake of the economy. However, Mahathir discarded the complaint and thought that *Bumiputera* entrepreneurs were too reliant on government facilitations instead of attempting to improve technology and increase productivity. Mahathir highlighted in his speech in Kuala Lumpur titled "The Way Forward" (Mahathir, 1991), "While all these socio-economic programmes were being carried out, the Government had also to ensure that economic growth would not be retarded. Indeed the NEP could not have been implemented if there was no growth, for it was premised on the expansion of the economic cake and not on redistribution of existing wealth."

Another key argument to support commercial liberalisation is that it creates competition and a competitive environment will bring in new technology and skills and consequently

[48] Overturning the resurgence of unemployment triggered by the recession and retrenchment processes.

improving the quality of manufactured products. Hence, the developing countries can enhance their export potential (Jomo, 2001a).

4.5.1. Financial Liberalisation

Prior to introducing the NEP, most banks were controlled and managed by foreigners and Chinese entrepreneurs. After the establishment of NEP, measures were undertaken to raise more Malay capitalists by setting up commercial banks and to urge them to give credits to *Bumiputera* entreprenuers. Consequently, the Malay-owned banks progressively improved in number during the 1970s. At that time, foreign banks were bound with stricter controls. "From 1983, foreign banks could not set-up new local office or branches in Malaysia. A foreign firms must follow the '60/40 borrowing guideline', that compelled the foreign companies to fund at least 60% of their loans with Malaysian banks" (Malaysia, 1971, 1976). Furthermore, "foreign stake in banks were capped at 30%. Consequently, the percentage of foreign bank's share of bank deposits was reduced to circa 30% from a high of 70% over a period of about 10 years, from 1980s to 1990s" (Athukorala, 2001).

However, the NEP resulted in moral hazard as certain banks were considered as "piggy banks" by certain Malay politicians patronising *Bumiputera* companies. This moral hazard was reassessed during the recession in the 1980s. For instance, Bank Bumiputera Malaysia Berhad (BBMB[49]), a bank established with the aim to offer business loans to *Bumiputera* entrepreneurs. However, proper credit valuation process were surpassed as political positions took higher priority. BBMB's NPLs ballooned and the bank was bailed out twice by the Malaysian government during the recession in the late 1980s based on the grounds that the failure of a large bank would hurt the Malaysian financial markets.

Given this incident, BNM had decided to liberalise the banking sector to the allow Malay-owned banks to withstand market forces and promote competition. Accordingly in 1991, BNM had abolished the restrictions on the base lending rate (BLR) to promote competition among banks. Concurrently, the market regulation and supervision

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[49] In the 1980s, BBMB was Malaysia's second-largest bank

frameworks were also tightened, by introducing a two-tier structure in 1994 (Gomez and Jomo, 1999).

Financial markets liberalisation became more radical in the late 1980s and early 1990s. The parliament passed the Banking and Financial Institutions Act (BAFIA) to govern the banking system, while Malaysian firms can only trade at the Kuala Lumpur Stock Exchange (KLSE) as KLSE broke away from Stock Exchange of Singapore (SES) in January 1990. In 1992, the Securities Act was passed to enable the establishment of a new Securities Commission (SC), which took over role of stock market regulation and supervision from the Capital Issues Committee (CIC), previously managed by BNM (Malaysia, 1986; BNM, 1998b).

"Foreign investor could increase their equity in domestic brokerage firms to 49%. An international offshore financial centre was also launched in Labuan IOFC[50] in October 1990 to promote Malaysia as a financial hub in Southeast Asia" (BNM, 1998a, 1999c). The primary aim of the Labuan was to draw interest in international investors for setting up offices away from their home country. The Labuan Offshore Financial Services Authority (LOFSA) was established in February 1996 for offshore banks to be governed by a more relaxed system (BNM, 1999c). This also resulted in another moral hazard as several Malaysian financial companies tapped into the more relaxed offshore centre to evade regulations. For instance, USD800 million loans by Malaysian commercial banks to Renong[51] and Hottick Investments (Hong Kong) was overlooked for a long time as Labuan was outside the supervision of BNM (Pura, 1998).

Table 4.2: Malaysia's Financial Liberalisation

	Items	Year
Financial Deregulation	• Removing regulation on interest rate of fixed deposits placed with commercial banks	1971

[50] Labuan is an island, northwestern Borneo in the South China Sea. In 1990 the island was declared a tax haven by the Malaysian government as the first step toward developing it into an offshore financial centre (https://www.britannica.com/place/Labuan).

[51] A big Malaysian-based conglomerate well-connected to UMNO.

	Items	Year
	· Lifting administrative control on all deposit rates of finance companies and fixed deposit rates (exceeding one-year maturity) of commercial banks · Freeing interest rates for deposits of 12 months and less and prime lending rates of commercial banks · Introducing new interest rate system to boost competition · Enacting the Future Industry Act to facilitate financial innovations	1973 1978 1990 1992
Institutional & Regulatory Reform	· The Banking Act - setting the legal and financial requirements for compliance by banking institutions · New provision of the Central Bank of Malaysia Ordinance of 1958 to resolve NPLs · The Bank and Financial Institution Act (BAFIA) - increasing minimum amount for capital funds (foreign banks should meet higher minimum capital adequacy ratio than domestic ones) · Establishment of the Securities Commission as a single regulatory agency	1973 1986 1989 1992
Foreign Exchange & Capital Account Liberalisation	· Transition to an IMF article VIII country[52] · Replacing the pound sterling with the US dollar in defining the exchange rate parity of the Ringgit · Establishing the Labuan Offshore Financial Service Authority (LOFSA) · Expanding access to Ringgit business	1968 1973 1996 1997

Source: Drawn from UN Economic and Social Commission as adapted in Lee (2004)

Generally, Malaysia's move towards financial liberalisation was steady and prudent (Yusof *et al.*, 1995), as illustrated by Table 4.2 above. Malaysia's pragmatic approached was to ensure minimum exposure to huge short-term foreign currency debts compared. By the end of 1997, Malaysia's debt was approximately 160% of its GDP, but the bulk of the debt was Ringgit debts, not foreign currency, unlike its neighbours (Lee, 2004).

[52] IMF Article VIII provides in Sections 2 and 3 that members shall not impose or engage in certain measures, namely restrictions on the making of payments and transfers for current international transactions, discriminatory currency arrangements, or multiple currency practices, without the approval of the Fund.

Short term capital flows were reduced by BNM' prudential regulations and preference of FDIs, explained below:

I. BNM's prudential regulations to reduce foreign currency-denominated loans by domestic companies. High loan growth in the 1990s, and exposure to stock markets and property created bubbles. BNM could deal with the drawback by selecting pre-emptive actions by making improvements in credit allocation and firming up of the prudential controls, especially on loans to share margins and real estates. Additionally, the Tier-1 minimum capital requirement for banks was raised in compliance with the Basel Accord (BNM, 1998a, 1999c).

II. The Malaysian authorities preferred FDI rather than portfolio investment as portfolio investment are regarded as more unpredictable than FDI. During the early 1990s, FDI amounted to 70% of the foreign capital inflows and 8.7% of the GDP (Athukorala, 2000).

The Ringgit Malaysia was initially pegged to the GBP under a currency board system since the late 1960s. In 1967, it was switched to a more flexible system and in 1972, the GBP was substituted by the US Dollar. However, after the demise of the Bretton Woods system in the same year, the Ringgit was no longer pegged to the US Dollar. The Ringgit was fixed to a traded-weighted basket of currencies and the regulated floating rate regime had effectively stabilised the exchange rate.

Since its independence in 1957, Malaysia's cross-border transactions had remained liberal. Malaysia was very much an open economy and had consistently adopted a method to economic progress that comprised the liberalisation of capital flows. The government carried out an initial phase of liberalisation on the foreign exchange regulations after adopting IMF's Article VIII obligations[53] in November 1968. Thereafter, the Ringgit was floated in 1973, adding extra measures to liberalise the capital account controls between 1986-87 and again in 1994–96 after periodic reviews of the exchange control regulations.

[53] Following more developed Asian countries like Hong Kong, Japan and Singapore, Malaysia was the 4th Asian country that received IMF's Article VIII obligation.

Beginning in the late 1980s, capital account liberalisation was increased by taking gradual steps of the deregulation of the financial structure. Major reforms were aimed at a steady interest rates liberalisation, credit controls cutbacks, and heightening of competition and effectiveness in the system. Considerable effort was made to intensify the financial markets, i.e. the enhancement of the regulatory and legal system, improving the monitoring processes and updating the regulations to tackle prudential matters. This included classification of loans and non-performing loans, requirements on provisioning and disclosure, clarifying the parameters on large exposures, bank liquidity position as well as capital adequacy.

In comparison with other Southeast Asia countries, Malaysia had managed a reasonably liberal system of cross-border transactions. Its path to liberalisation was distinct from other Southeast Asia countries due of its unique importance on social aspirations together with economic progress and there was fundamental consensus among political front-runners that social aspirations of the NEP was not abandoned. The Mahathir administration realised that liberalisation had potential in-depth ramifications for a country that centred its doctrine on ethnic unity. His pseudo-egalitarian administration could not be substantiated if he failed to protect the NEP. However, the financial crisis had driven the government to reassess its relaxed approach towards capital account liberalisation.

4.6 Conclusion

The period between 1957 to 1996 is important as it sets the tone for Malaysia's political and economic nature in the years to come. The chapter has reiterated a consistent development policy with a strong objective in improving the social and economic imbalance between the multi-ethnic groups in Malaysia. It has showed that in managing the expectations of Malaysia's two major communities and its own expectations, the post-independence administration employed policies that created self-reinforcing institutions that led to the formation of two autonomous communities with exclusive sets of institutions.

In managing the Malay expectations, the chapter has described how the NEP and Islamisation policy led to set off processes that helped raise Malay expectations, increase

Malay capacity and create a repertoire of Malay-based institutions. Even though the NEP to a certain extent achieved its objective of poverty eradication, portrayed by the analysis of Table 4.3 below, it had also created some moral hazard in turning *Bumiputera* entrepreneurs to be too reliant on government support (Mahathir, 2010).

Table 4.3: Poverty eradication in Peninsular Malaysia under the NEP (1970-90)

Ethnic group	Percentage of households below the poverty line (%)	
	Year 1970	Year 1990
Bumiputera	65.0	20.8
Chinese	26.0	5.7
Indian	39.0	8.0
Other	44.8	18.0
Total	49.0	15.0

Source: Government of Malaysia (1991, p. 46)

No two countries are really similar in all matters, as each country will have to plan its own core development philosophy, policies and plans. The Malaysian government would have had a full comprehension of the challenges facing the country and its people and would take the appropriate actions to address them in a relevant, pragmatic and politically tolerable manner. The protection of NEP would have not been in favour of other ethnic minorities, especially the Chinese, as they did not directly benefit from it. However, they did not reject it totally as they were conscious of the possible implications based on their knowledge of Malaysia's history. Malaysia had to persevere with the selected philosophy, policies and plans but be pragmatic and adaptable so that the policies will remain relevant and suitable to fluctuating environments.

In summary, a country must have the wisdom and willingness to act independently and in its own interest, especially in the light of a financial crisis. The Panic of 1997 if not managed with caution, taking into consideration all aspects of the country's circumstances, rather than just its financial well-being may turn into an intense socio-political turmoil as it did in Indonesia (Choi, 2001; Frost, 2016).

However, critics of the NEP had argued that without the NEP, Malaysia may have achieved better economic growth. This argument is probably correct but would have come at the cost of social divergence and worsened the income disparity. Indonesia is a country similar to Malaysia in terms of its demography during the 1990s but was the only country that did not recover from the Panic of 1997 as the intervention from IMF had ignored the non-financial elements of the country, in the context of deep social and political unrest.

CHAPTER 5: RESTRUCTURING OF FINANCIAL SYSTEM

"If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew"

(Quran, 2:280)

"The 1997–98 Asian financial crisis was a major turning point for macroeconomic management and financial sector policy in Malaysia. It triggered a series of deep macro-financial reforms in Malaysia that have transformed the country's financial system into a resilient, diversified and sound one 20 years later"

The World Bank (2017b)

5. Introduction

Since a financial crisis would have a significant impact in the social and economic well-being of the country, Malaysia's NEAC had responded immediately by initiating actions to maintain the financial market stability. After the Panic of 1997 hit Thailand, the NEAC believed that it was crucial for Malaysia to maintain financial stability that it had enjoyed over the last two decades. A stable financial market is when savings are allocated efficiently to investment opportunities. This will ensure that available resources are allocated efficiently towards promoting economic expansion and development (BNM, 1998b). The Panic of 1997 had put Malaysia on the edge of a potentially great recession, and the whole of the country's economy registered a negative growth rate of 7.5% in 1998, the per capita income contracted by more than 1.8% in 1998, and the KLSE composite index dropped by 44.9% during the period from 1 July 1997 to 31 December 1997 (Azmi and Razak, 2014). The NEAC had decided that it was crucial to implement strategies to promptly restore trust and confidence to strengthen the financial sector. Malaysia's immediate response was to sanction the short selling of blue-chip shares and buy shares from domestic shareholders to prop up stock market prices.

This chapter, divided into three parts, will study the financial market reform initiatives as one of the main policy responses in achieving financial market stability as proposed by the NEAC. The first part of this chapter will briefly examine the financial market performance in Malaysia before the Panic of 1997, and then it will analyse the management of debt from an Islamic perspective. It will also study the rationale behind the NEAC's decision and the process of undertaking this strategy in stabilising the financial market in Malaysia. The second part of this chapter will study in detail the establishment of the three special purpose government agencies that was set up to undertake this special task of policy implementation i.e. Danaharta, Danamodal and the CDRC. And finally, the third part of this chapter will analyse briefly the financial system reforms that were undertaken by the other crisis-affected countries in the Southeast Asia, namely Indonesia, Thailand and Korea[54] as a comparative review. This analysis is crucial as a comparative review of the financial system reforms in these countries were part of IMF's conditions for the financial aid that it had provided. The analysis will summarise the similarities and differences of the financial system reforms approaches undertaken by these countries and their impact on the economic and social well-being of the countries.

The pre-crisis economic conditions in the Southeast Asia countries including Malaysia, had aggravated the effects of the Panic of 1997 via rapid economic expansion in the 1990s. The economic expansion had enabled financial institutions to increase their loan growth substantially, comfortably making provision for losses and expanding their capital bases. During these years of high economic prosperity, there were increasing credits to fund economically unsound investments and other inadequate lending activities i.e. connected lending, high exposure to single customers, and excessively high sectoral loans concentration. Teo (2000, p. 14) stated that when the impact of the Crisis eroded companies' repayment capacity, the financial sector was suddenly faced with sharply increasing NPLs, loan-loss provisioning requirements, eroding collateral values and deteriorating capital bases.

[54] Similar to Malaysia, both Indonesia and Thailand are also NIEs of the HPAEs. Korea is a North East Asia HPAEs as categorised by the East Asian Miracle report by the World Bank (Chapter 2). Korea is the most affected Northeast Asia HPAEs as compared to Hong Kong, Singapore and Taiwan.

5.1 Malaysia's financial market performance prior to the Panic of 1997

This section examines the performance of the Malaysian financial sector during the period prior to the Panic of 1997, specifically after the recession in 1985/86 up to 1997/8. It will focus on the commercial banking sector as commercial banks distinctly dominate the financial sector as it holds 74% of total assets at the end of 1998 as compared to other financial institutions.

Table 5.1: Commercial banks (including foreign banks) - Key performance indicators

	1988	1995	1998
Number	38	37	35[1]
Branch network	911	1433	1,690[1]
ATM network (*machines*)	861	2230	2,647[1]
Number of employees	41605	64461	71124
Assets[2,3]	98200	295460	459190
Net Non Performing Loans (NPL)[4,5]	8706	4332[6]	16739
Net NPL as percentage of Total Loans[4,5]	17.8	1.9[6]	5.9
Income and expenditure[2]			
Interest income (net of interest-in-suspense)	4972.2	16889.1	42763.0
(*interest-in-suspense*)[7]	1469.8	331.6	1589.3
Less: Interest expense	3418.7	10100.6	29400.1
Net interest income	1553.5	6788.5	13362.9
Add: Non-interest income	1705.4	3067.5	4958.0
Less: Bad debt provisions[8]	704.9	735.0	12189.3
Staff costs	909.9	2280.9	3167.0
Overheads	965.0	2013.7	3622.5
Pre-tax profit	679.1	4826.4	(657.9)
Coarse performance measures			
Assets per employee	2.36	4.58	6.46
Pre-tax profits per employee	16 323	74 873	(9250)

Source: BNM (1994, 1999) as adapted in Dogan and Fausten (2003).

Note:

Except for the first four and last rows all figures are in RM million, pegged exchange rate of RM3.8 per USD

[1] From BNM Annual Report 2000.

[2] At financial year ends.

[3] Includes Bank Islam Malaysia Berhad.

[4] At calendar year ends.

[5] Net NPL: Gross NPL− (interest-in-suspense) – (specific provisions for doubtful and bad debts).

[6] 1996 figures.

[7] When a loan is classified as NPL, interest income is not recognised until it is realised on a cash basis.

[8] Bad debt provisions consist of special and general provisions. General provision is made to cover possible losses which are not specifically identified.

The commercial banking sector underwent significant growth even though the total number of commercial banks declined slightly from 38 to 35 (Table 5.1). The aggregate data shows that networks had nearly doubled, the number ATMs increased threefold, and substantial increase in the number of employees and total assets. According to a study by Dogan and Fausten (2003), commercial banks showed that the financial outcome from the 1985/6 recession had resulted in net NPL of 17.8% of the commercial banks' total loans by the end of 1988. Rapid economic improvement during 1990–1996 boosted earnings and improved debt servicing by the banks' customers. Pre-tax profits increased seven-fold during the economic recovery phase from RM679 million (USD178.7 million) to RM4.8 billion (USD1.26 billion), while the NPL ratio declined to 1.9%. The rapid banking expansion continued until the Panic of 1997 hit the Malaysian economy.

The initial policy response on 24-25 March 1998 initiated by Finance Minister Anwar had dramatically reversed the improvement on the NPL ratio. One of the immediate measures to be adopted by the financial institutions was to bring loan classification standards to international best practices, i.e. the current classification of 6 months for NPL to 3 months. Other stricter measures were also implemented, such as expanding capital adequacy framework to incorporate market risk, reducing single customer limit from 30% to 25% of capital funds and more intensive and rigorous supervision including conducting monthly stress tests on individual banking institutions (NEAC, 1998). This was a prerequisite for Malaysia to accept a RM1 billion (USD263 million) loan from the World Bank for social and poverty-related projects, with the aim that the structural reform in the financial sector should include more transparency and disclosure for banks and companies (NEAC, 1998).

Consequently, the NPL ratio had tripled the point it had reached the previous 3 years to 5.9% (Table 5.1). The sector suffered an aggregate pre-tax loss of RM657.9 million (USD173.1 million), which indicated an RM5.5 billion (USD1.45 billion) reversal over three years, and a reduction of roughly 200% from the already low level at the onset of the decade. Some advancements towards financial liberalisation were carried out during the early 1990s, most notably BNM's removal of controls over interest rates i.e. in February 1991, banks were allowed to set their own deposit and lending rates (Dogan and Fausten, 2003, p. 207). Other reforms involved the "scope of investment of commercial banks in both equity and private debt securities; streamlining the classification of NPLs, suspension of interest on NPLs and provisioning for bad and doubtful debts; guidelines for minimum audit standards for internal auditors of financial institutions and duties and responsibilities of directors of financial institutions" (BNM, 1999c). Concurrently, certain quantitative lending directives that relates to the NEP remained in effect. Malaysian commercial banks and finance companies were compelled to allocate a particular amount of credit to priority sectors including the *Bumiputera* business community of Malays, small and medium-sized companies, and prospective homebuyers from lower middle-income groups (Randhawa, 2011). The mandated priority lending requirements had to be met by financial institutions as a group (BNM, 1999c).

5.2 Management of Debt in Islam

The fundamental principle of any framework that deals with distressed debt is the effort taken to fulfil the obligation itself. The Quran makes specific mention that debt obligation must be repaid as well as the appropriate treatment for dealing with debtors who are in financial difficulty. The most direct example of this principle is in the opening verse of the surah Al-Maidah,[55] 'Oh, ye who believe! Fulfil your obligations' (Quran,5:1). The word obligation or *Aqad* in arabic originated from the root word for "knot" or "tie". *Aqad* also means a promise or a binding contract, which is the essential foundation for the law of contracts in Islam. Similar convictions were revealed in other verses in the Quran and Islamic scholars indicated that the *Aqad* or contract in Islam is equivalent to the legal principle *Pacta sunt servanda*[56], Latin for 'agreements must be honoured' (Herman, 2016).

This notion on the importance of debt repayment is reinforced by the *Sunnah* where the Prophet Muhammad ﷺ defends a creditor who had harshly demanded a camel from the Prophet, a camel that the Prophet owed him. The creditor's harshness towards the Prophet angered his companions, but the Prophet stated that the creditor had his rights. The Prophet then instructed his companions to give the man a better camel, remarking that

[55] All English translations of the Qur'an are based on either Yusuf Ali's or Marmaduke Mohammad Pickthal's widely used translations.

[56] The *pacta sunt servanda* is a basic principle in contract and international law.

"the best among you are those who repay their debts handsomely"[57]. There were several related *Hadith* on the significance of debt repayments, where the Prophet stated, "Procrastination in repaying debts by a wealthy man is injustice"[58] and the Prophet also mentioned that a martyr will not enter paradise until his debt is paid off (Drew, 2018, p. 130).

Furthermore, a collection of *Hadith*s also paints a daunting picture of the perils of being in debt and the failure to repay. In one often repeated narrative in Islamic teachings, the Prophet's wife, Aisha, recounts her conversation with the Prophet[59] where she asked him why he so often seeks God's "refuge . . . from all sins, and from being in debt." He responded, "If a person is in debt, he tells lies when he speaks, and breaks his words when he promises." It was also revealed in the Quran, dishonesty or untrustworthy are characteristics that are detested in Islam, "It is most hateful in the sight of Allah that you say that which you do not do" (Quran 61:3). In addition, the Prophet Muhammad ﷺ had warned the people after his time that there will come a day where trustworthiness barely exists in business dealings. Trustworthiness is a very critical aspect in day-to-day transactions, for it relates to fairness in all aspects of life. However, it is impossible to avoid dishonest transactions completely. In a related *Hadith*, the Prophet Muhammad ﷺ also said "People are just like camels; out of one hundred, one can hardly find a single camel to ride."[60]

In Islam, believers should try their best to fulfil their obligations, trusts and contracts with other people, for default will not display good character. As stated in the Quran, one must take precaution even when dealing with the people that you trust: "O you who have believed, when you contract a debt for a specific term, write it down… bring to witness two witnesses from among your men…" (Quran 2:282). Islamic teachings via the Quran encourage proper documentation and caution in transactions so that fraudulent and unethical dealings will be mitigated. Nonetheless, the Quran also guides the creditors on how to deal with distressed debtors: "If the debtor is in difficulty, grant him time till it is

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[57] A hadith compiled by Sahih Bukhari (38:502) as narrated by Abu Hurairah RA.

[58] A hadith compiled by Sahih Bukhari, (41:585; 37:486) as narrated by Abu Hurairah RA.

[59] A hadith compiled by Sahih Bukhari, 41:582, narrated by Aisha RA.

[60] A hadith compiled by Sahih Bukhari, 76:505, narrated by 'Abdullah bin 'Umar.

easy for him to repay. But if you remit it by way of charity, that is best for you if you only knew" (Al-Baqarah 2:280). This verse translates to Islam encouraging debt forgiveness, provided there is a sound reason for such an act e.g. layoffs, financial crises and natural disasters (Amin, 2017). While voluntary remission is favoured and will be rewarded, the decision for the discharge of a debt is left to be decided by the creditors and not made mandatory (Herman, 2016).

In dealing with debt management from a macroeconomic perspective, it is important that a crisis-affected country like Malaysia maintains financial market stability to prevent the possibility of a banking crisis. Stability can be achieved when there is trust and confidence in the financial market. In a corresponding *Hadith* on state intervention that was narrated by Anas ibn Malik[61]: "Prices rose during the time of the Prophet Muhammad ﷺ and the People said O Messenger of Allah, prices have shot up, so fix prices for us. He said: Allah is the One who fixes prices, the One who withholds, the One who gives lavishly and provides, and I hope that when I meet Allah, none of you will have any claim on me for an injustice regarding blood or property."

Based on the above *Hadith*, a majority of Islamic scholars are of the opinion that the state should not interfere in fixing prices (Drew, 2018, p. 82). However, Islahi (1996, pp. 95–96) argued an alternative view on the *Hadith* based on the works of Ibn Taymiyah[62] that government may only interfere if there is a real need, such as when there is injustice in the market or when people's lives are at risk.

5.3 The Policy Response – Maintain Financial Stability

In an economic crisis, stabilisation of the market takes preference over market equilibrium, and without a stable environment even the most viable of companies would fail (Chellappah, 2001, p. 77). Financial stability is achieved when the financial institution

[61] A sound hadith recorded by Ibn Majah in Sunan Abu Daud, Book 23, hadith 3444 (English translation).

[62] Ibn Taymiyah (1263-1328) was a prominent and controversial Syrian thinker, theologian, Hanbali jurist, and political figure. His intellectual activities, preaching, and politics resulted in persecution and imprisonment. Main doctrine was the supremacy and authoritativeness of the Quran and *Sunnah* of Muhammad and the early Muslim community.

framework operates efficiently and there is confidence in the financial markets. Malaysia's central bank, BNM's primary objective is to promote a solid and efficient Malaysian financial system. A system that can combat negative economic cycles and shocks. Therefore, it must take measures in preventing excessive interruptions to the existing framework, while preserving significant confidence in the financial system.

Financial instability and its effects on the economy can be highly disastrous due to its contagion or spill-over effects to other parts of the economy (Schwartz, 2002). Hence, it is necessary to have a solid and robust fiscal structure to reinforce the dynamic reserves allocation and risks dissemination across the economy (BNM, 1998a, p. 5). Financial instability can have either monetary or non-monetary causes and may be solely domestic or spread among countries. Anna Schwartz (1988, p. 53) cited in (Bordo and Wheelock, 1998, p. 41) argues that a central bank "that was able to maintain price stability would also incidentally minimise the need for lender-of-last-resort intervention". Financial instability, according to Schwartz, has often been caused or made worse by fluctuations in the aggregate price level. A monetary policy that maintains price stability would thus also promote financial stability.

One crucial pillar of national cohesion is effective internal financial systems. Weak financial systems can destabilise local economies and make them more vulnerable to external shocks, despite sound macroeconomic management. Villiger[63] (2001, p. 40) highlighted that "global instability originates from poorly regulated and often distorted financial sectors, lack of transparency and ineffective risk management systems". Whilst, Bordo (1998, p. 44) defined financial crisis as a "banking panic, which is an event characterised by widespread depositor runs on banks, leading to a decline in the deposit/currency ratio and possibly many bank failures. A banking panic is also characterised by contagion, or runs, on solvent banks."

The Panic of 1997 had resulted in the collapse in the stock market and significant depreciation of the Ringgit, which caused the health of the Malaysian financial system to deteriorate. Malaysian traditional lending practices have relied on collateral rather than

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[63] Minister of Finance, Switzerland delivered a paper on risk and insurance at the 27th General Assembly of the Geneva Association, Zurich, 24 May 2000.

credit assessment or cash flow analysis (Lindgren *et al.*, 2000, p. 14), which made them vulnerable to excessive risk-taking and reductions in asset price. The NEAC had immediately identified the weaknesses in the Malaysian financial system and narrowed the three most important factors that needed to be addressed (Danaharta, 1998a, p. 18):

i) Rapid credit expansion with unusually high exposure to property and stock markets;

ii) Substantial short-term domestic debts; and

iii) Increasing NPLs.

The NEAC had established 3 distinct agencies to sort out the problem of the NPLs and shortage of capital. The plan also involved financial and corporate sector restructuring that would hasten the pace at which market confidence and robust economic growth were restored.

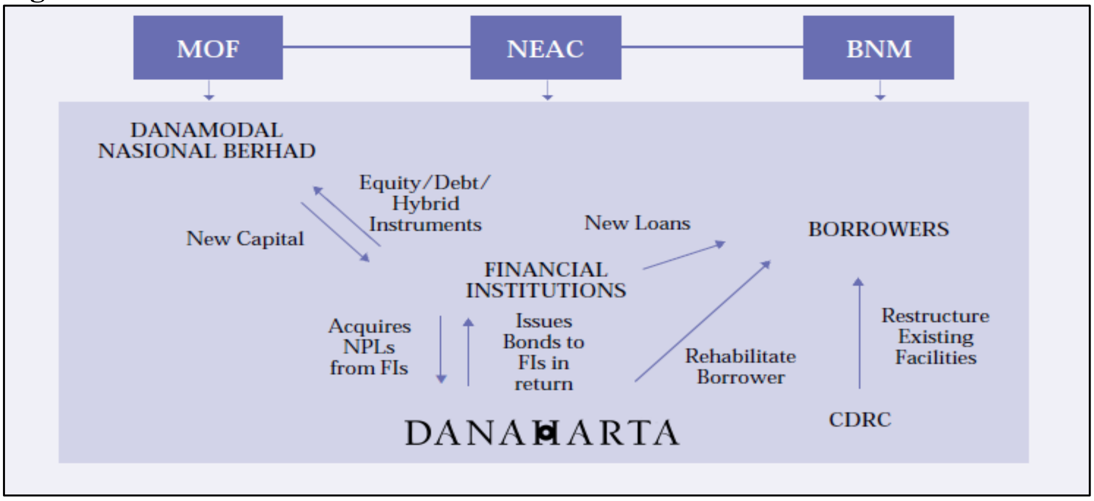
1) **Danaharta**, an asset management company (AMC) wholly owned by the Malaysian government via the MoF. Danaharta was created to acquire NPLs at current market price from the troubled banks (Chotigeat and Lin, 2001, p. 54).

2) **Danamodal,** a special purpose agency owned by BNM was set up with 2 objectives. First, to carry out the task of recapitalising the financial institutions by providing interim financing. Second, to facilitate the consolidation and rationalisation of financial institutions via mergers and acquisition (Majid, 1999, pp. 2–3); and

3) **CDRC**, a committee under BNM was formed in August 1998 to facilitate discussions between borrowers and financial institutions to enable voluntary restructuring of debts to realise a greater collective benefit. (Azman, 2003, p. 3).

The roles of Danaharta, Danamodal, and CDRC (hereafter defined as the AMC Framework) complemented one another and they were separately governed by their respective operational frameworks. A Steering Committee was set up to regulate the AMC with BNM's governor as the chair (Danaharta, 2005). This was an important pre-emptive measure by the NEAC in the stabilisation and strengthening of the financial system. The quick rationalisation of Malaysia's economy was to ensure that the risk of potential banking crisis was mitigated (Danaharta, 1998a).

Figure 5.1: The Financial Institutions Reform Framework



Source: Danaharta (1998a, p. 18)

In a crisis-affected economy like Malaysia, a critical factor for a successful strategy for sustainable recovery and economic growth is a cost-effective financial and corporate sector restructuring. The planned economic recovery could fail with an unhealthy financial system and an insufficient supply of credit. Lenders will not consider a potentially viable corporate that is afflicted by a financial crisis without the intercession of a corporate debt restructuring. The NEAC believed that a combination of sound macroeconomic management and reforms is required to strengthen the financial system and corporate governance in Malaysia.

The Panic of 1997 had caused serious financial problems for many companies in Malaysia. This led to many borrowers not being able to service their loans. Consequently, banks and finance companies recorded high levels of NPLs (Gabriel and Parameswaran, 1998). As an initial policy response by Anwar, banks and financial institutions tightened their lending policies. They were also forced to switch their focus to recuperating the growing NPLs on their books, rather than loan growth. The bank's tight lending policy had deprived good businesses from getting fresh funds that were much needed to generate economic activities. The negative impact on the economy had pushed the Malaysian government to consider improving rescue mechanisms and resulted in the NEAC's primary focus to control the rising numbers of NPLs and other effects of the Panic of 1997 (Azmi and Razak, 2014). In dealing with the rising NPLs, Danaharta was establish to buy NPLs from financial institutions and Danamodal to carry out recapitalising the financial institution[64] (Danaharta, 2005).

5.3.1. The AMC Continuum

So far, similar SPVs that have been created globally to tackle the problems of NFLs stemming from banking crises can be roughly classified into three categories:

i) At one end, there are rapid disposition agencies which dispose of assets within a limited timeframe, generally at fire-sale prices, and will often have mandatory acquisition powers. For example, the Resolution Trust Corporation of the United States, that was established in response to the banking crisis in the 1980s (Peiser and Wang, 2002) and the Financial Restructuring Authority of Thailand, which was set-up to deal with assets of 56 finance companies (Montreevat, 2003).

ii) While on the other end, there are warehousing agencies, which typically acquire the NPLs of the financial system and warehouse these assets, with minimum effort put in to capitalize on the gain of the assets. Such an operation would typically wait for the market to restore before initiating the disposal of its assets. But in reality, the market may never fully recuperate, as it is burdened by anxieties about the overhung assets placed in the agency's portfolio (Danaharta, 1999b).

iii) Lastly, in between the two extreme are the AMCs which are actively involved in the management of its assets and will undertake to maximise the revival value before disposing of the assets (Schäfer and Zimmermann, 2009). An outstanding and successfully implemented AMC was Securum[65] of Sweden Asset Management Company (AMC).

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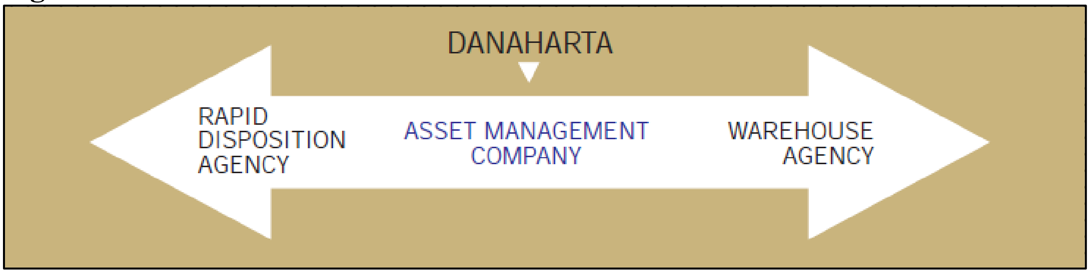
[64] *Dana* in the Malay language means Fund, *Harta* means assets or properties and *Modal* means Capital, translated to English, Danaharta and Danamodal means Assets & Property Funds and Capital Funds, respectively.

[65] The Swedish approach to the banking crisis by transferring troubled debt to specialised asset management companies. Wholly owned by the State, Securum's "board and management was given a great deal of freedom in shaping the company's policies. Moreover, the board was dominated by experts, with representatives of the ministry and the political domain being a limited element" (Bergström, Englund and Thorell, 2003).

In summary, the standard asset management continuum indicates the rapid asset disposition type of AMCs on one extreme and the warehousing type of AMCs on the other extreme (Danaharta, 1999a, p. 62). Malaysia had followed the more market-oriented technique in handling the NPLs, which lie in the heart of the continuum (Figure 5.2).

Figure 5.2: The AMC Continuum



Source: Danaharta Final Report (2005)

The NEAC's choice to follow the Securum model was due to "Securum being a hugely successful AMC as it was able to keep the cost of the bail-out below 2% of GDP, and was able to return about 58% of its initial equity back to the government" (Danaharta, 1999a, p. 62). Initially, it was estimated that it would take up to 15 years for Securum to take care of all these assets, but it took slightly over 5 years to complete its job (Englund, 2015). Based on the study by Shäffer & Zimmerman (2009, p. 219), realistically, it is usually assumed that an AMC will produce a loss in the end. However, this can be more readily compensated if these losses remain low by an appreciation in value in other areas. For instance, through the increased in value of the managed or foreclosed assets. Therefore, certain prerequisites needed to be fulfilled for the government to have a good chance of recouping its investment in the AMC (Schäfer and Zimmermann, 2009, p. 219):

(i) toxic assets were acquired from the bank at a cheap price;
(ii) active management of these assets is possible;
(iii) financial experts with specific know-how of such assets;
(iv) time is available; and
(v) a clear governance structure has been implemented.

AMCs are basically a cost mitigation scheme intended to safeguard the legitimacy of a financial framework, rather than the option of a failed financial system that would be more costly and harmful for the country (Danaharta, 2005). Other countries such as Indonesia, Thailand and Korea had diverging issues affecting them and selected different methods of implementing their restructuring. For example, in Thailand the bankruptcy and foreclosure laws are comparatively weaker (Montreevat, 2003) as well as the sheer size of the loan's portfolio (in terms of the number of accounts). It was therefore more sensible for them to dispose the assets via auction. It would have been administratively challenging to manage such assets as small loans including hire purchase contracts and residential mortgages formed a significant amount of the assets.

On the other hand, Korea's KAMCO had taken the '*rapid disposal approach'* (Figure 5.2) in dealing with the non-performing assets (Kang, 2009), although their problems are more manufacturing-inclined rather than property-related as is the case in Malaysia. In Indonesia where the structure of the financial system is more delicate, the government required an all-encompassing agency such as IBRA to facilitate and implement the restructuring process. According to Terada-Hagiwara and Pasadilla (2005), no two asset management companies are and can be alike, due to the different circumstances and governance framework which exist in each region. A study to ascertain which method is the most ideal would be an ineffective exercise, but it is helpful to analyse the various approaches by each country and to pick out lessons from their experiences.

5.3.2. Danaharta: NPL resolution

The MoF formed Danaharta on 20 June 1998 as a state-owned company set-up under the Companies Act 1965 and wholly owned by the Ministry of Finance Incorporated. It was a pre-emptive measure to avoid the threat of a banking crisis in Malaysia. The primary aim of Danaharta was to recuperate the Malaysian financial sector by managing the rising level of NPLs and maximising their recovery value. The Malaysian government had funded Danaharta, a common practice of AMCs around the world and guaranteed Danaharta's borrowings. Danaharta also established two wholly owned specific purpose subsidiaries to manage the NPLs of Sime Bank Group and Bank Bumiputera Group on behalf of BNM. BNM paid fees for their services and in turn, all recovery proceeds were to be transferred back to BNM (Danaharta, 2005). Danaharta also created other subsidiaries to manage the assets that were tagged with the loan. The subsidiaries were divided by assets class such as properties, leisure, and manufacturing (Danaharta, 1998a). This allowed for specific expertise to address similar assets and stay focus on their task.

The Malaysian government via MoF and BNM provided the initial funding to Danaharta and Danamodal and stood behind the issuance of approximately RM13.2 billion (USD3.47 billion)[66], which came from 3 sources (Danaharta, 2004b, 2005, p. 20):

i) Bonds issued to the selling banking of RM8.2 billion (USD2.16 billion)

ii) Malaysian government contribution of RM3 billion (USD0.79 billion) and

iii) Malaysian government loans of RM2 billion (USD526 million).

The effect of the financial turmoil, as reported by BNM (1998), was evident by the increase of NPLs in the first half of 1997 from RM1.43 billion (USD380 million) to RM10.14 billion (USD2.67 billion) in the second half of 1997 (3.6% and 5.7% of total loans, respectively). In its initial year, Danaharta had acquired RM8.11 billion (USD2.13 billion) gross value of NPLs, from 37 financial institutions, which was approximately 25% of the banking system's NPL (Danaharta, 1998a). It had also in the same year, acquired assets under management for a further RM11.62 billion (USD23.06 billion) relating to the Sime Bank Group, bringing the total under Danaharta's care to RM19.73 billion (USD5.37 billion) (Danaharta, 1998a).

Danaharta had concluded its initial carve-out of NPLs by end-June 1999, immediately after its formation and acquisition phases. Its chairman stated in its Annual Report (Danaharta, 2000) that by March 2000, a secondary carve-out exercise was completed with no further acquisition exercise carried out to be considered. Based on its Annual Report for the year ended 2000 (Danaharta, 2000, p. 23), Danaharta had approximately RM47.49 billion (USD12.5 billion) of NPLs at gross value by December 2000. This consisted of RM20.39 billion of NPLs acquired from financial institutions ("FIs") together and RM27.10 billion from the Sime Bank Group and Bank Bumiputera Group, the NPLs managed by Danaharta's subsidiaries[67]. Upon the completion of the two NPLs

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[66] Translated at USD1:RM3.80, the rate of the Ringgit Malaysia was pegged as a policy response in stabilising the Malaysian currency.

[67] Danaharta had set-up 2 wholly owned subsidiaries to manage the assets of Sime Bank Bhd and Bank Bumiputera Bank Berhad on behalf of BNM, with capital of RM1.5 billion (USD0.39billion) and

carving-out exercise in the year 2000, Danaharta was able to focus on managing and resolving the NPLs in its portfolio.

Danaharta's task was to acquire the NPLs from the banks so that it would allow the banks to focus on their principal business of supplying credit. The aspirations of Danaharta were two-fold (Danaharta 2005):

(i) To permit the banks to focus on lending to support the economic improvement by eliminating the distraction of managing of NPLs; and

(ii) To maximise the recovery rate of the NPLs in its portfolio.

Danaharta commenced its operations by buying NPLs within 3 months of the notice of its conception in 1998. This was done via a special mechanism where the banks disposed their NPLs at an agreed fair market value to Danaharta. The mechanism is essential because Danaharta was established as a pre-emptive measure to avoid a banking crisis. Accordingly, a carrot and stick method was used as it did not have compulsory acquisition rights (Danaharta, 1998a). Danaharta would offer the selling banks a surplus sharing structure where any excess by Danaharta from the disposal less its acquisition cost was distributed between the selling bank and Danaharta on sharing basis of 80:20, respectively.

5.3.3. The Legislative Framework

After establishing Danaharta's targets, NEAC realised that it was a challenge to achieve those targets if Danaharta was not given the appropriate mechanisms, especially to encounter the anticipated legal disputes in the acquisition and restructuring of the NPLs. Danaharta needed to be provided with the necessary authority to drive its operations easily and quickly. The solution was to draft a new law that would provide the framework for Danaharta's operations, especially the special powers to undertake its given tasks.

RM0.75billion (USD0.20billion) were injected into the banks, respectively, to meet the minimum capital adequacy ratio of 8% (BNM, 1998b).

The parliament urgently passed a new legislation in August 1998, that provided the configuration for Danaharta to launch its challenging mission. The statute was called the Pengurusan Danaharta National Berhad Act 1997 (the Danaharta Act) that had enabled Danaharta to function as prophesied by the NEAC and as evidence that Malaysian government had given its full statutory backing. Whilst enjoying special rights to enforce its function adequately, it provided Danaharta with enhanced flexibility concerning its business and financial activities (Azmi and Razak, 2014, p. 385). Azmi (2014) stated that the Danaharta Act reflected "the Government's desire for Danaharta to operate along commercial lines with the key principle to adopt a market-driven approach, regardless of the fact that it was a government-owned entity".

The NEAC knew that it had to set up Danaharta at a surprising pace because the faster it could carry out its mission, the better for the economy. It was incorporated as a company, rather than a government agency to ensure the flexibility and minimised any red-tapes. In addition, being a company supported the notion that commercial principles were followed wherever feasible, for example, cost minimisation and maximisation of the recovered value. It was a unique organisation in many aspects. Even though Danaharta was a statutory company, it was given exceptional rights to deal with NPLs when the Danaharta Act was enforced on 1 September 1998.

The Danaharta Act basically sets out Danaharta's principal aim to acquire, manage, finance and dispose of assets and liabilities of troubled banks. The Danaharta Act gives Danaharta three special powers (Danaharta, 2005):

1. The power to buy assets via *statutory vesting* – this is critical to allow Danaharta to buy the assets with the certitude of title;

2. The power to take on special administrators to administer the activities of distressed companies; and

3. The capability to quickly dispose of foreclosed assets.

These included the requirement to disclose conflicts of interests and obligations of secrecy. Danaharta's Memorandum of Association described its powers and regulated how it was to be operated (Malaysia, 1998). The Danaharta Act sets out the blueprint that facilitated efficiency, commercial viability, and effectiveness of Danaharta's operations. Statutory vesting allowed Danaharta to acquire the required title to assets based on a defined set of obligations without unjustifiably disrupting the interests of other lenders (Danaharta Act 1998). However, in 2000, modifications to the Danaharta Act were brought in by the Pengurusan Danaharta National Berhad (Amendment) Act 2000, which refined existing provisions of the Danaharta Act by eradicating any doubt about its assumed effect and to overcome practical complications that emerged after Danaharta began operations (Azmi and Razak, 2014, p. 385).

The refinements were required to clarify the ambiguities that came up when the Danaharta began its operations and to iron out further issues, especially those linked to statutory vesting and special administrators. The special administrators offered a much-needed choice for maximising value, with capable expertise to the turnaround of distressed companies. Otherwise, the banks would increasingly look to winding up and holders of collaterals will rush to administer their securities, which would unquestionably bring down weakened enterprises and ultimately lessen the value of the assets to the very minimum (Danaharta Act 1998).

As time was of essence, the Malaysian government passed the new legislation fairly quickly. Even though existing laws were sufficient to allow Danaharta to do its work, they would normally involve time-consuming legal proceedings. Since Danaharta must relieve the banking system of its mounting NPLs to stop a systemic catastrophe within a given period, it was under immense pressure to act. The contagion impact of the Panic of 1997 had caused the financial industry to be confronted with an alarming escalation of NPLs. Administratively, it was a challenge to deal with the possibility of thousands of NPLs within a short period. The NEAC knew that the quicker Danaharta could fulfil and complete its given special task, the greater the benefits to the economy and taxpayers. The NEAC had to ensure that the Danaharta Act would enable Danaharta to carry out its operational activities expeditiously and minimise the risk of any court proceedings.

5.3.4. Statutory Vesting

Statutory vesting as prescribed in the Danaharta Act essentially allowed Danaharta to assume a similar position of the vendor bank. Danaharta was then able to take the same interest and enjoy the same arrangement as the vendor bank, subject to registered interests and disclosed claims. For instance, if the vendor bank had a first charge over property as security for the loan, Danaharta will likewise have the same first charge over the property. Additionally, if a second charge had been registered over the property by another bank, this second charge would continue to exist without any change in preference (Danaharta, 2005). Another task of Danaharta was to deal with the NPLs of financial institutions that were also newly acquired by the BNM. For example, the Sime Bank Group was acquired by BNM as part of the restructuring plan. For this purpose, Danaharta had formed a wholly owned subsidiary, Danaharta Managers Sdn Bhd, with the sole purpose of dealing with the NPLs belonging to the Sime Bank Group, on behalf of BNM.

Another crucial feature of the Danaharta Act is its *Section 72*, which basically restricts the awarding of any injunction against Danaharta. It is to ensure that Danaharta does not encounter an unwarranted setback, as delays cost money and would invariably burden the taxpayer. However, the Danaharta Act does not prohibit an aggrieved party from suing Danaharta and receiving compensation. It is worth noting that the agreement to declare *Section 72* void does not mean that Danaharta cannot perform its duty. It can work as other powers remain intact (Danaharta, 2002, p. 11).

5.3.5. The Operations of Danaharta

Danaharta was set up as a flat organisation structure but designed to be flexible to accommodate the different phases of its life (Figure 5.3). Flexibility in the structure is vital, as the scope of work and focus will transform through the various phases of its development. During the initial stage, the soul of Danaharta rests in its operations unit that was integrated and supported by six auxiliary Departments (Danaharta, 1998a, p. 20). The operations unit managed loan recovery and supervision and launched its loan acquisition exercise in late August 1998 .

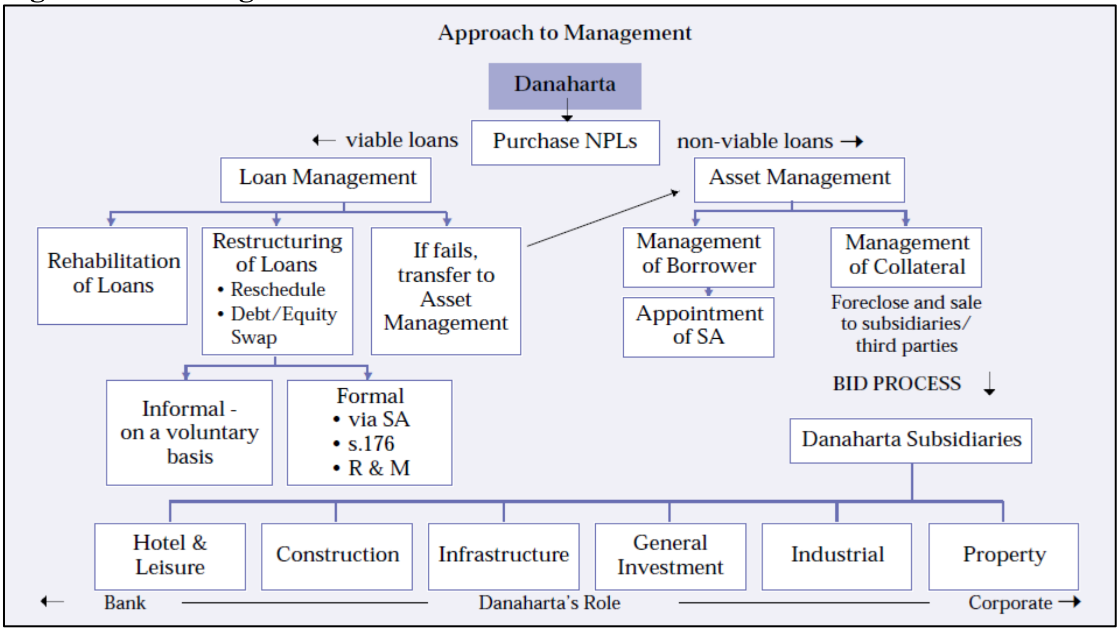
The preliminary acquisition method was to do business with all banks on a first-come, first-served basis. Gradually, this was replaced by a more structured method declared on 6 October 1998, which prioritised the purchase of NPLs according to the different categories and loan types. Typically the priority in its loan acquisition exercise would be in accordance by loan type, the approach simplified as follows (Danaharta, 1998b):

i) The viable loans will be restructured;

ii) Non-viable loans, the assets attached as collateral (involving the sale of the collateral or the business) will be restructured;

iii) All foreign loans were disposed of.

Figure 5.3: Management of NPLs



Source: Danaharta (1998a, p. 37)

It also looked at the strength of the banks in its approach, priority given to the frail banks (specifically those undergoing recapitalisation assistance from Danamodal) before dealing with the stronger institutions. The weaker banks are easier and faster to deal with due to their financial conditions.

5.3.6. Loan Restructuring Guidelines

The NPLs were carefully assessed for its viability and if a loan was identified as viable, Danaharta would apply restructuring approaches such as the rescheduling of loans and/or debt-equity conversions. In this regard, Danaharta had developed a series of comprehensive guidelines to facilitate it in the overhauling of viable loans (Danaharta, 1999c, p. 4). The following objectives were also considered in drawing up the guidelines and structure for Danaharta (Danaharta, 1999a, p. 34):

i) To maximise the overall revival rate and interests to Danaharta;

ii) To minimise the engagement with taxpayers' fund;

iii) To provide adequate treatment of all shareholders; and

iv) To utilise where appropriate Danaharta's special powers to leverage and benefit the financial system in its entirety.

Danaharta only accepts loans above RM5 million (USD1.6 million) to retain effectiveness in dealing with its asset resolution function, and this covered more than 70% of the total countrywide NPLs (Fung *et al.*, 2004). The restriction on size and age of the NPL accounts applied by Danaharta as its guidelines had contributed to the broad quality of its acquired assets and improved its recovery performance. These guidelines were aimed to improve lucidity in Danaharta's operation while concurrently providing the borrowers and their advisors with a basis for a workout plan. Loan restructuring proposals advocated by Danaharta must adhere to these guidelines and detailed rationale must be given for deviations from these guidelines (Danaharta, 1999b, p. 18). As mentioned earlier, Danaharta also managed whole NPLs portfolios of entire banks, which were acquired by BNM. Separate subsidiaries were specifically set up for this purpose to ring-fence these NPLs portfolios from the NPLs acquired directly by Danaharta.

During its lifetime, Danaharta incorporated several subsidiaries to prepare for subsequent tasks in administering the acquired assets. Danaharta's subsidiaries were each expected to have a distinct principal activity such as property development, hotel, recreation assets and manufacturing assets. This provided for pools of talents to be developed to focus on assets of the same characteristic (Danaharta, 1998a, p. 16). For instance, a Property Division was set up in 1999 with the task of managing Danaharta's property assets from the anticipated foreclosure exercises (Danaharta, 1998a, p. 20).

5.3.7. Sufficient Funds

For most AMC, funding issues will usually have important implications on their operations, loss-sharing among funders, and bond market development (Fung *et al.*, 2004, p. 28). As the appointed national AMC, Danaharta must be able to raise enough funds to finance the NPLs acquisition. Fung (2004, p. 28) highlighted that since most state-owned

AMCs are expected to be loss making, henceforth, the concern of dividing the loss among the fund's providers would be a concern. However, this issue is less significant in Danaharta's case since its operations are entirely funded by the government, either directly or via guarantee.

A cost-effective way of financing the AMC is via the national budget or via issuing of tradable government securities or bonds. This has the added benefit of boosting bond market expansion by raising the capital market liquidity (McCauley, 2003). However, the affected Asian countries chose to maintain their debt obligation off-balance sheet and instead preferred to guarantee the bonds issued by the AMC. Fund raising via guarantee approach is more costly than direct government bonds and do not contribute much in the local bond market development because they are either non-tradable or only with limited liquidity (Fung *et al.*, 2004). Gabriel and Parameswaran's (1999) interview with Danaharta's managing director revealed that the estimated funding requirement of RM15 billion[68] (USD3.95 billion) is sufficient due to several factors.

i) The bad loans of 2 banks that amounted to RM14 billion[69] (USD3.68 billion) were not part of the loan to be acquired as they fall under exclusive arrangements with BNM, where Danaharta were only to manage the loans;

ii) Malaysia's financial system was strong enough to tolerate an NPL level of up to 9%, therefore not all the bad loans in the system needed to be removed;

iii) The acquisition of NPLs were market driven as NPLs were bought at market value at a discount of 40 to 50%; and

iv) The funding required by Danaharta were revolving as some assets were disposed as part of its operation.

Moreover, Danaharta was compelled to minimise costs as much as possible through leverage since it had only a capital base of RM1.5 billion (USD0.39 billion) in a system with RM70 billion (USD18.42 billion) worth of NPLs. Special powers were given to Danaharta under the Danaharta Act, where it did not have to take out the entire loan before

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68 Estimated based on maximum anticipated NPLs of 20 to 25 percent

69 The loans of Sime Bank (RM7 billion) and Bank Bumiputera (RM7 billion) were acquired by BNM and managed by a subsidiary of Danaharta on behalf of BNM.

restructuring them. The leverage power of Danaharta, which sets it further apart from other AMCs, means that there is no minimum threshold which needs to be satisfied before it can invoke the administrative powers (Gabriel and Parameswaran, 1998).

5.4 Danamodal: Capitals and Mergers

During the Panic of 1997, banks that were saddled with sizeable NPLs became financially weakened and eventually under-capitalised. A substantial number of the afflicted banks was at the risk of breaching the prudential banking limits. Danamodal was incorporated in August 1998, two months after the setting up of Danaharta. It was established as a special-purpose vehicle with the task of recapitalising financial institutions with capital adequacy ratios (CAR)[70] below 9% (Kawai, 2000). Danamodal was assigned by the NEAC to carry out two primary tasks:

i) Recapitalisation of the weak and failing banks in the industry - Danamodal was to provide provisional funds to facilitate the banks in satisfying their capital adequacy requirements. Danamodal’s capital injections were in the form of equity and/or hybrid instruments; and

ii) Facilitation on the consolidation and rationalisation of the financial system.

Danamodal was established as a limited liability company and a wholly owned subsidiary of BNM, with a defined lifespan of 5 years. Danamodal's funding requirement was initially estimated at RM16 billion (USD4.2 billion) with BNM providing an initial seed capital of RM1.5 billion (USD0.39 billion). The balance was derived from issuance of exchangeable bonds with a participation of domestic and foreign institutional investors and multilateral agencies (Bacha, 1998). After only 1 year of operation, Danamodal with total funding of RM11 billion[71] (USD2.9 billion) infused fresh capital of RM6.2 billion (USD1.63 billion) into financial institutions that in the aggregate represented roughly one-fifth of industry assets (IMF, 1999b, p. 65).

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[70] Capital Adequacy Ratio (CAR) is the “ratio of a bank’s capital in relation to its risk weighted assets and current liabilities. It is decided by central banks and bank regulators to prevent commercial banks from taking excess leverage and becoming insolvent in the process” (BNM, 2018).

[71] The funding comprised of RM3billion in capital provided by BNM and RM8 billion zero coupon bond.

5.4.1. First task: Recapitalisation

For a period of 5 years, Danamodal injected RM7.6 billion into 10 financial institutions affected by the financial crisis (Fung *et al.*, 2004, p. 36). The capital infusion was structured as a debt that can be converted to share capital called the exchangeable subordinated capital loans (ESCLs). Additionally, Danamodal had signed definitive agreements with 9 of the 10 banks for the conversion of ESCLs into permanent Tier 1 and/or Tier 2 capital[72] (BNM, 1999). The capital injection, which equals to approximately 14% of the entire Tier 1 capital of the banking sector at the onset of 1998, had helped improve the CAR of the banking system to 12.3% at the end of April 1999 (Kawai, 2000, p. 148). The improvement of the CAR was supplemented by absorption of losses by shareholders through reduced shareholding in the institutions, change in the composition of the boards of directors and/or transformation in management (Zainal-Abidin, 2000).

Danamodal's recapitalisation exercise had safeguarded the frail banks from breaking the prudential banking limits and ensured that the banking sector continued to operate as a lending vehicle to corporations and individuals (Azmi and Razak, 2014, p. 383). Having the improved capital position coupled with operational restructuring, financial institutions were steered into a better financial standing and were able to focus on providing finance to businesses that could lead to Malaysia's economic revival (Azmi and Razak, 2014, p. 383).

5.4.2. Second task: Bank Mergers

The plan for bank mergers had been long advocated by BNM, even prior to the Crisis, but was not well accepted by the banking industry. Given that BNM had a stake in the recapitalised banks via Danamodal, this had enabled the central bank to carry out its plan of the financial industry consolidation and initiated its original plan of bank mergers. Based on statistics collected by the World Bank (2017a, p. 24), there were more than 77

[72] The Basel Committee classifies "bank capital identifying 3 different levels: Tier 1 capital, Tier 2 capital, and Tier 3 capital. They are characterised by increasing degree of liquidity and decreasing degree of redemption priority and ensure the coverage of financial losses, i.e., the bank survival. Tier 1 capital identifies the main components of equity capital: shares, unavailable balance sheet reserves, and shareholders' retained earnings, accrued over the life of the bank. It represents the amount of capital that allows a bank to absorb losses without affecting interests of depositors."

banks prior to the Panic of 1997. Furthermore, it was in the interest of the central bank to encourage banks to merge and form larger, more viable units to enable them to compete in an increasingly liberalised global financial system. At that time, existing institutions did not have the resources to compete with their regional peers or provide a wide array of products and services.

Following the Panic of 1997, BNM had put in place a set of policies which facilitated the financial sector consolidation leading to the number of financial institutions reduced from 77 to 44. The financial institutions merger was carried out throughout 1999 and continued well into 2003, whereas the banking sector had progressed into 10 stronger well-capitalised domestic banking groups (World Bank, 2017b). The capital adequacy of the banking system improved subsequently, and the NPL declined. The statutory reserve requirement was reduced in several rounds from 13.5% in February 1998 to 4% by September 14, 1998 (Hood, 1999, p. 8).

The restructuring of the banking sector resulted in more resilient well-capitalised banks which are owned by institutions rather than individual shareholders. Nonetheless, Danamodal's endeavours during this stage of financial instability also led certain quarters to the conviction that the company was utilised to bail out ailing banking institutions (Jomo, 2006). However, the argument by Jomo (2003) of Danamodal being a rescue vehicle was refuted by analysing the restrictive structure of Danamodal itself. BNM had only 3 representatives on the board of Danamodal, despite the provision of a seed capital of RM1.5 billion (USD0.39 billion). The other members of the board were from the private sectors, apart from a nominee from the Ministry of Finance. There were also some representatives of the international investment community. In addition, the company also published regular financial statements for transparency and kept the public informed of its activities. Danamodal was therefore a pre-emptive measure to facilitate the banking sector's rationalisation and avoid a banking crisis, rather than an emergency rescue mission (Business Times; Kuala Lumpur, 1998).

5.5 BNM’s role

The amount of BNM’s exposure to the potential banking crisis was restricted to its capital contribution of about RM3 billion (USD0.79 billion) in Danamodal. However, Danamodal had managed to receive nearly 100 percent returns on its investments by the end of 2001, mainly via the consolidation of banking institutions (Fung et al., 2004, p. 36). Danamodal had also appointed their representatives in the recapitalised banks to ensure that these banks were managed prudently and efficiently as well as to introduce changes that would strengthen these institutions. (Zainal-Abidin, 2000).

The real benefits of Danamodal's establishment towards the domestic banking sector were only realised at the end of its tenure. When Danamodal finally disposed of its interests in Malaysia's banking systems, the banking sector become healthier, resilient and better prepared to face the international banking giants (IMF, 1999b). At the time of winding up in 2003, Danamodal had redeemed its entire RM11 billion (USD2.89 billion) 5-year bonds (ESCLs) on 21 October 2003 and had remaining assets of RM2.2 billion (USD580 million) (BNM, 2003a, p. 108). Danamodal was wound down on 31 December 2003, five years after its establishment in 1998. The government via the Danamodal successfully advocated the mergers of banks rather than the closures or sale to foreign entities, and tightly orchestrated Malaysia's financial sector restructuring program (Kawai, 2001). Danamodal has managed to recover its entire capital investment through the gradual divestment via the banking sector rationalisation exercise. (BNM, 2003b).

BNM formulated the Financial Sector Masterplan (FSMP) in 2001 to align the development of the financial sector to that of the economy (BNM, 2001). The main objective of the FSMP according to BNM's report (2001c) is "to develop a more resilient, competitive and dynamic financial system with best practices, that supports and contributes positively to the growth of the economy throughout the economic cycle, and has a core of strong and forward looking domestic financial institutions that are more technology driven and ready to face the challenges of liberalisation and globalisation" (Lee, Tuck and Koay, 2011). In short, the underlying purpose of BNM's FSMP was to promote financial stability.

5.6 CDRC: The Mediator

The last piece of the NEAC's AMC Framework was the CDRC, which was set up in August 1998 to aid voluntary restructuring of corporate debt outside the courts through voluntary negotiations between creditors and borrowers (Kawai, pi]2000, p. 148). The

CDRC took on the role as a secretariat, which supervised and facilitated negotiations between the creditors and debtors. It acted as a mediator between the companies and their lenders in reaching a viable debt restructuring arrangement.

In an economic downturn, the banks' immediate response may be to precipitate the liquidation of viable companies to get their money back as soon as possible, due to a high level of stress in the economic system. However, this is not necessarily the best course of action for the economy. Hence, the CDRC was established to steer the restructuring of corporate debts to avoid the reckless winding up of viable businesses.

Corporate restructuring via CDRC is important, as it can in the long run preserve the productive capacities of viable companies which contribute positively to the nation's GDP. In order to pre-empt liquidation of the company, which has far-reaching adverse affects both financial and social, the borrowers seek to renegotiate with their lenders regarding modification of the terms of the loan (Jessica, 2012).

5.6.1. CDRC's modus operandi

For the companies that have applied for CDRC's assistance, independent advisors were appointed and granted 60 days to draft a restructuring scheme. The proposals were examined by the CDRC on its viability, whether it is justifiable to the financiers and companies' shareholders. The proposal was to be enforced only when all parties conceded. They were principally debt voluntary workouts between the borrowers and creditors with the CDRC giving input on the exercise. Voluntarily corporate debt restructuring is the most desirable option to legal actions as highlighted by Gray (1999) as cited in Azman (2003, p. 3). This approach is cost effective and brings in the most desirable results as compared to alternative methods such as enforcement or liquidation proceedings.

The CDRC would determine if it is feasible for the proposal to raise some capital. The proposal might also require the approval of certain authorities such as the Securities Commission, BNM, the Foreign Investment Committee or the Kuala Lumpur Stock Exchange. The CDRC, as a government committee played an advisory role in the restructuring process and assisted in liaising with the relevant authorities to facilitate fund raising. It would act in the national interest when determining the viability of a company.

The Committee essentially needed to determine whether the business involved was critical and viable in the context of the general economy and whether it was in the public's interest to be sustained. As a check and balance, the independent consultants only assessed the viability of the business from a purely financial angle. The financial viability was a very important consideration because otherwise, the company would have to be liquidated. Other considerations included the social impact of liquidation and whether the business was of strategic value to the nation. However, if a company was not commercially viable but served some national interest, the Steering Committee of CDRC was consulted. The matter would be analysed from both a micro and macro point of view while considering other non-financial affects to the country.

Generally, CDRC anticipated the bankers to concede to the restructuring schemes because loan recovery would be maximised as compared to liquidation processes where the values may not be so easily realised. However, given a deadlock situation where the bankers were not willing to participate in the restructuring of the company, the CDRC would solicit out an amenable third party such as Danaharta to acquire the NPLs.

The NEAC was of the view that under conditions of financial calamity, liquidations would mean that the bank would not be able to recover the full amount owed to them. Furthermore, liquidations would highly likely put an end to strategic assets that could contribute to the national economy. Therefore, CDRC's objective was to provide the platform and expertise to facilitate the smooth restructuring of a company. It aimed to advise the affected financiers to consider the long-term benefits rather than short term profit gain. Proposals were made on a voluntary basis and initiatives were set in place to ensure that all avenues were made accessible to aid viable businesses to rehabilitate their debt commitments (Azman and Muthalib, 2003).

Fundamentally, the underlying purpose of the CDRC's mediation was to ascertain that both the borrowers and creditors work out reasonable debt restructuring schemes without having to resort to legal proceedings. It was noted that many borrowers and creditors in critical financial conditions had sought legal protection under Section 176[73] of the Companies Act 1965, rather than explore alternative options such as debt restructuring (Ariff and Abubakar, 2003). The formation of the CDRC debt-restructuring framework together with the Creditor Committees, which included bank representatives, was to work out how the debts would be restructured. These are but a few instances of the efforts initiated to hinder the failure of what was deemed strategic businesses (Ariff and Abubakar, 1999, p. 7).

5.6.2. Challenges faced by CDRC

Loan mismatched - borrowed short to fund its long-term projects

It was reported that most of the applications to the CDRC consisting of loans that were mismatched (Rajandram, 1999). In a continuously liquid capital market, such a mismatch is still viable and acceptable; however, in an economic meltdown loans mismatched would have negative consequences. Given such, the CDRC would attempt to remedy the problem by finding ways and means of converting short-term bank borrowings into longer-term funding. This could take the form of conversion into equity or longer-term bond issues.

[73] Under section 176 of the Companies Act 1965 (now repealed), "a company in financial distress can only restructure by a scheme of arrangement (Malaysia, 1965). The use of the scheme of arrangement became synonymous with corporate rescue measures in the 1997 financial crisis in Malaysia when financially distressed companies frequently used the restraining order provisions in section 176 to secure extended judicial protection from creditor actions. The application for a restraining order became open to abuse by companies without any viable proposal for a scheme of arrangement, whether by way of a deferred payment plan or a compromise. Section 176 also allowed the existing management to continue in management without adequate protection for creditors against dissipation of assets and inappropriate application of cash resources."

Lack of corporate governance in the non-financial sector

The Crisis had exposed the lack of corporate governance in the non-financial sector. Many conglomerates took on high-risk projects and were over-borrowed, over-extended and over diversified, thereby becoming vulnerable to shocks (Shanmugam, 2000).

Management transformation of the affected companies

The modus operandi of the CDRC was based on the London approach, a flexible framework which enables banks and debtors to agree on a debt workout (Smith, 1996). Similarly, the CDRC acted in the capacity as advisor via an advisory committee. Only shareholders of the company could vote for the changes to the management if they were not happy with it (Gradinaru, 2009). The creditors could typically request on either board representation or a representative into the company. The CDRC would advise either the shareholders or creditors if such remedial action needed to be undertaken.

5.6.3. Restricted power as a mediator

Up until 2000, the CDRC had received a total of 67 applications, and of these, only 19 debt restructuring schemes were resolved. This represented approximately 28% of the total cases. The slow progress of the work of the CDRC can be attributed to two factors:

(i) The CDRC was merely a mediating entity that facilitated negotiations between borrowers and lenders. It bore no statutory right to impose any debt-restructuring solutions. This was unlike Danaharta, which had extensive rights because it was set up by an act of parliament, while Danamodal had none (*Southeast Asian Affairs; Singapore*, 2000).

(ii) Reaching solutions to debt restructuring was challenging due to the fact that all creditors must concur to the restructuring scheme. Banks were hesitant to settle the debt without full compensation. Negotiations have then been lengthy because even a single opposition from one creditor could threaten the entire restructuring process (Dzulkarnain, 2001).

Given this, the NEAC had responded that from 1 August 2001, Danaharta and the CDRC were to have a common chairman so that efforts by both parties could be closely coordinated (Danaharta, 2001). It resulted in quicker resolution of CDRC cases as the special powers of Danaharta was capitalised where necessary. On 31 July 2002, CDRC was officially dissolved, having dealt with 47 cases with a total debt of about RM44 billion (USD11.58billion) (Danaharta, 2002, p. 11), which represented approximately 65% of the total cases under the committee. The CDRC was revisited in 2009 and turned into an informal corporate rescue work-out agency. This was a pre-emptive move against any possible upsurge in NPLs anticipated after the global financial crisis (Azmi and Razak, 2014, pp. 382–383).

5.7 The Final Score Card: review of similar frameworks

Malaysia had five options available in handling with corporate sector's financial distress, stretching from the extreme outright liquidation, to a mutually agreed debt restructuring and reorganisation of the company (Thillainathan, 1998, pp. 181–184). The five options were:

i) winding up under the Companies Act 1965, where the provisions under liquidation are extensive and provide a logical basis for winding-up;

ii) engaging in a scheme of arrangement and reconstruction under the Companies Act which deals with rehabilitation of companies as a growing concern;

iii) debt restructuring under CDRC;

iv) sale of the firms' loans by financial institutions to Danaharta; and

v) restructuring of small borrowers by individual debt workout.

The first two options were spelled out in the Companies Act 1965 but the remaining options only emerged as a response to the Panic of 1997. In the best interest of the country, NEAC had sought to minimise the likelihood of the first two options by setting up the AMC Framework. The Panic of 1997 had brought about distinct policy responses from the afflicted countries in the region. The three IMF-assisted Asian countries, namely Indonesia, Thailand and South Korea initiated the bank restructuring programmes which consisted of the setting-up of agencies to handle NPLs in the banking system, comparable to Danaharta. Countries such as China and Japan have too set up structures to deal with their NPLs problem. However, the operational structure, modus operandi and statutory structure of these agencies were different from those of Danaharta (Danaharta, 1999a, p. 56).

As a non-profit special purpose company, Danaharta's objectives were to alleviate NPL pressure and maximise revival values and not profit-oriented. In addition, Danaharta progressed through its life-cycle very quickly as it had a finite life. The objectives in each stage of its development were different. Specialised key performance index (KPIs) had to be pieced together to gauge the work and effort, both from a quantity and quality perspective. These KPIs were designed to drive the organisation to reach its key targets. Over time, different KPIs came into play with some overlapping between phases and each KPI had an assigned benchmark. Based on a study by Fung et al. (2004, p. 41), Danaharta had almost resolved its entire portfolio of acquired assets within four years of its establishment and were able to meet or exceed the benchmarks set for all of its KPIs (Danaharta, 2005).

It is important to foster market discipline in AMCs and a simple method is by exerting a significant level of transparency. The AMCs in Indonesia, Korea, Malaysia and Thailand disclosed their activities by publishing annual reports with financial statements. Some AMCs go to greater extent in displaying transparency by instituting internal audit panels as well as having external audits carried out by independent auditors. For example, Korea's KAMCO and Thailand's TAMC released annual reports audited by an international accounting firm, Indonesia's IBRA provided monthly reports, which disclosed data on asset revivals and other activities, whilst Danaharta produced an operational report every six months describing its activities and vital statistics (Fung *et al.*, 2004).

Table 5.2: Analysis of key indicators and policy responses in 4 Asian countries

	Malaysia	**Indonesia**	**Thailand**	**Korea**
AMC, SPVs and Agencies	i) Danaharta ii) Danamodal iii) CDRC	· IBRA	i) FRA ii) Thai AMCs	i) Korean Deposit Insurance Corporation ii) KAMCO
Latest NPL ratio (% of total loans)	6.6% (Dec 1999) (Malaysia reports NPLs on a net basis while the others report on a gross basis)	57.0% (Dec 1998)	38.5 % (Dec 1999)	8.2% (Sep 1999)
IMF Assistance	N. A	USD42.3 billion	USD17.2 billion	USD57 billion
Financial institutions closed, merged or nationalised	· 2 banks merged with stronger banks	· 66 banks closed · 4 state banks merged · 4 banks taken over by IBRA	· 56 finance companies nationalised · 2 banks nationalised	· 5 banks closed · 2 banks nationalised
Approach	· Danaharta removes NPLs · Danamodal recapitalises banks · CDRC facilitates corporate debt restructuring	· IBRA handles restructuring and rehabilitation of the banking sector, including bank recapitalisation and NPLs resolution	· FRA disposed assets of closed financial companies via auction · Thai AMC acts as the bidder of last resort · 10 banks (public-owned and private) have set up their own AMCs	· Korean Deposit Insurance Corporation recapitalises the banks · KAMC O removes NPLs

	Malaysia	Indonesia	Thailand	Korea
Sunset	2005	2004	2011	None
Special Powers	Yes	Yes	Yes	None
Acquisition	Loans worth more than RM5 million	No preselection	Loans worth more than BT5 million	No preselection but KAMCO had discretion on what assets to acquire
Pricing	Market value with profit sharing of 80:20 in favour of the FIs	Zero value but government shouldered any bank losses	Market value with profit-sharing	Market value with put and buy options
Disposition strategy	• Use of special administrators for different type of assets • Use of foreign expertise	• Corporate loans via auction, direct sale, asset-bond swap • Commercial loan via outsourced management and collection • Small loans via settlement • Divestment of bank shares	• Auctions, direct sale, debit rescheduling • Settlement • Outsourcing of management of assets to Thai entities	Extensive use of foreign partners via Joint Ventures: • JV-AMC • JV-Corporate Restructuring Companies • JV-Corporate Restructuring Vehicle

Source: (Danaharta, 1999a) & (Terada-Hagiwara and Pasadilla, 2005, p. 11)

The BIS's analysis on the success of AMCs in Southeast Asia was summarised in the Danaharta Annual Report (2003, p. 104) and (McCauley, 2003). The paper examined various key factors that led to the successful operation of the AMCs and these key factors are mapped to Malaysia's AMC Framework:

Table 5.3: Analysis by the Bank of International Settlement (BIS)

	Key factors as presented by BIS	**Malaysia's AMC Framework**
1.	**Strong political will:** An essential starting position for any successful AMC is a strong political advocacy on the part of the government to address NPLs in the system. However, an AMC should work independent of political intervention and be given enough autonomy.	Danaharta, Danamodal and CDRC were professionally run without any political intervention. Support was only given via funding and legislative requirements.
2.	**Explicit government financial assistance:** The state should finance the AMC's activities directly through its budget. If an AMC were to issue its own bonds or borrow funds, an explicit government guarantee is required to enhance the financial positions of the banks and the AMC.	Funding was from the Malaysian government by way of direct lending, equity contribution or guarantee.
3.	**Supportive legal framework:** An adequate legal system including insolvency and foreclosure laws to support the AMC. The AMC should also be accorded certain statutory rights that allow the AMC to deal with its assets expeditiously and to obtain a higher revival rate.	A new legislation was passed for this purpose that gave Danaharta special powers to execute its duties.
4.	**Efficient market situation:** Smooth-operating capital markets facilitate asset transactions, while permitting foreign investors to acquire assets from the AMC will further boost up asset disposal, specifically when the domestic capital market is not so well established.	The Malaysian government via the Securities Commission and BNM worked on developing the Financial Sector Masterplan 2001-2010.
5.	**Clear AMC mandate:** The AMC must have well-defined targets and clear-cut policies for its operation, such as the types of assets to be acquired and the resolution methods it can employ. It should concentrate on asset transactions and not be unduly hampered by large corporate restructuring.	The three agencies were given clear distinct mandates, but their roles complement each other.

	Key factors as presented by BIS	Malaysia's AMC Framework
6.	**Well defined AMC life:** Generally, the life of an AMC should be determined upfront to avoid it from hoarding on the acquired assets for a lengthy duration, for fear of realising large losses on disposal. Nevertheless, the life span should also be reasonable enough for an AMC to have enough time to deal with the assets under its management.	All three agencies had different predetermined life: Danaharta – 7.5 years Danamodal – 5 years CDRC – 5 years
7.	**Adequate governance:** The AMC should have a solid internal control system and effective external oversight and be verified periodically by an independent accounting firm.	Danaharta published 6 monthly operations reports for transparency.
8.	**Good transparency:** The AMC should periodically publish the audited results of its operations in a form that can be clearly appreciated by the public and the market.	The annual reports and operational reports were audited by a recognised international accounting firm.
9.	**Speedy resolution:** The AMC should plan for immediate disposal of acquired assets. Waiting for an economic turnaround to enhance recovery often leads to slower resolution proceeding and greater losses.	Danaharta's approach was only to restructure viable assets, while non-viable assets are disposed immediately.
10.	**Realistic asset pricing**: Normally, assets should be handed over to an AMC at market-based prices, specifically for privately controlled banks. Appropriate stimuli, such as option-like profit/loss sharing arrangements, or enforcements would help facilitate such asset transfers.	Danaharta had acquired the NPLs at the current market price with profit sharing of 80:20 in favour of the banks.

Source: (BNM, 1997, 1998a; Danaharta, 1998a, 1999a, 2003, 2005; McCauley, 2003; Fung *et al.*, 2004)

Even at the early stages of its operations, Danaharta had gained global recognition, manifested by the fact that Danaharta has progressively become the subject matter of research by academics and economists globally. Since inception until its wind up in 2005, regional NPL resolution companies or foreign state officials had requested for official study visits to Danaharta for closer examination and understanding of Danaharta's concepts and techniques. Multilateral firms like the World Bank and IMF had paid Danaharta periodic visits seeking to confirm their comprehension of Danaharta's modus operandi. At one stage, Danaharta hosted a contingent of 40 Members of Parliament from Indonesia and even officials from the United States Treasury (Danaharta, 2000, 2005).

Pomerlano (2009) as cited in Randhawa (2011) noted that a well-coordinated effort between Malaysia's three agencies culminated in their successful dismantling after they had fulfilled their agenda. CDRC was wrapped up in 2002, Danamodal in 2003 and Danaharta wound down at the end of 2005. These institutions were created to deal with various aspects of the Panic of 1997 and had managed to successfully complete their mandate. The immediate cost of the bailout to the Treasury was less than 5% of the GDP (Randhawa, 2011, p. 397). The AMC Framework had successfully addressed the concerns of the NEAC, i.e. resolved NPL problems, rationalised the banking system and encouraged corporate restructuring (Zainuddin, 1999).

5.8 Conclusion

The restructuring efforts and structural reforms carried out by the AMC framework after the Panic of 1997, have strengthened the structure of banking system and achieved the objective of the NERP of financial market stability. Amongst the efforts was the bank and financial institution merger and consolidation scheme that was initiated in 1999 and concluded in 2000. The consolidation scheme was successful in strengthening the fragmented domestic banking sector (Danaharta, 2004a, p. 109).

The guiding principle for the NEAC's policy response was based on the best interest of the country or *Ummah*. Mahathir being the executive chairman of the NEAC was a forceful advocate in implementing the NERP without any financial aid from the IMF, as he truly believed that any policy intervention from the IMF would result in the reversal of the NEP. However, the *Bumiputera* entrepreneurs and their political sponsors to a certain did manage to exercise political pressure on the restructuring activities and distorted the restructuring process.

CHAPTER 6: MANAGING CAPITAL CONTROL

> "Malaysia has experienced the globalisation of capital and we were nearly destroyed by it. Fortunately, we were able to develop our own methods to defend ourselves and rebuild our economy. We know that our success may be short-lived but we are not going to allow ourselves to be sold ideas, ideologies and slogans without carefully examining them. If we find the slightest suspicion that another agenda is being promoted we will fight tooth and nail to defend our country and the prosperity of our people."
>
> Mahathir Mohamad (2000b)

6. Introduction

This first part of this chapter explains the events that led to the decision on the policy in response to the Panic of 1997. It examines the rationale based on historical events that took place that led the Malaysian policy makers in employing unconventional policies. It then analyses why other Asian countries, such as Korea, Thailand and Indonesia, had carried out orthodox policies, in contrast to Malaysia's response. In terms of macroeconomic stability, these countries stood to a pro-cyclical policy while Malaysia followed a counter-cyclical policy and the utmost distinction is in its foreign policy. Malaysia had enforced capital controls with a fixed exchange rate regime, whilst the rest of the affected Asian countries relaxed their capital account controls towards a floating regime.

Malaysia is a country that consists of parliamentary democracy and a constitutional monarchy, which means policies are passed through parliament and assented by the monarch. However, Mahathir's authoritarian leadership style had managed to dictate substantial policy decisions in his favour. Sven (2018) argued that most political analyses of the Mahathir years, draw attention to his constantly growing authoritarian powers.[74] Mahathir had systematically eradicated sources of dispute, whether within the party, among the monarchs or within the judiciary system. Mahathir turned parliament into somewhat of an irrelevancy by making some of the most important policy announcements outside of the parliament. He also eroded the functions of the cabinet as well as ministerial bureaucracy by elevating the roles of unelected bodies of his handpicked appointees such as the members of the NEAC. Hilley's (2001) comprehensive study of Malaysian politics argues that his 22-year reign also coincided with a notable diversification of legitimacy, away from relying on the coercive means of the national state security of 1970s alone into one marked by higher levels of consensual, popular support (Hilley, 2001, pp. 75–76). This consensual support from Malaysians of different backgrounds was based on the economic success as well as his vision for Malaysia's emerging and more inclusive national identity.

The analysis seeks to uncover the archaeology of Mahathir's ideas and to link them with the parallel processes that eventually contributed to the historically controversial capital controls policy. Mahathir (2011) argues that two major historical events led him to steer his administration in the establishment of such policy responses:

i) Malaysia's experience during the tin trading on the London Metal Exchange (LME) and

ii) Concerns on the impact of the NEP, if IMF's proposals were accepted and implemented.

6.1 The London Metal Exchange (LME)'s Tin Trading Lessons

Mahathir just became Prime Minister in 1981 when the price of tin tumbled. Tin was an important commodity to Malaysia as it was the world's largest tin producer since the 1960s with a share market of 26-33% (World Bank, 1981). Whilst at the other end of the spectrum, the United States was the single most significant tin consuming country with a share of about 21% of the total world consumption, trailed by Japan with 14% of the share

[74] Mahathir was appointed as the Prime Minister on 16 July 1981 and stayed in office for 22 years, resigning on 31 October 2003.

(World Bank, 1981). As the dominant consumer, the United States clearly opposed any export controls and favoured large buffer stock as an alternative. However, it left itself open to the charge of inconsistency by opposing compulsory consumer contributions to the buffer stock while refusing to make a voluntary contribution itself (McFadden, 1986). McFadden (1986) further highlighted that the U.S. confrontationist strategy was largely responsible for widening the gap between producing and consuming countries. As the member of the International Tin Council[75] (ITC), the United States worked consistently to limit official increases in the price range to levels at which the ceiling was almost always below the market price. This strategy eliminated the possibility of export controls or buffer stock purchases because under ITC rules, price support mechanisms were not allowed when the market price was above the official ceiling (Lowe, Warbrick and Cheyne, 1987).

In June 1981, Malaysia had attempted to increase the price of tin, under the guidance of commodity trader Marc Richie.[76] Richie had advised Mahathir to set up a subsidiary company owned by a government agency to handle the concealed purchases of tin futures on the LME. These covert purchases were funded by Malaysian banks and designed to further support international prices for the metal, which were being depressed continuously by the US trade terms, a global recession, tin recycling and its aluminium substitution. Just when Malaysia's purchases of future contracts and physical tin looked to be succeeding, the LME changed its delivery rules, letting short sellers off the hook, resulting in a sudden drop in tin prices of about 20%. As a result, Malaysia experienced nearly RM600 million (USD260 million)[77] loss in the tin trade on the LME (The New York Times, 1982). The LME experience was a lesson for Malaysia and had made a significant impact on Mahathir's foreign policy outlook. Mahathir (2011) believed that

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[75] ITC is a cartel administered by the 23 members of the Sixth International Tin Agreement (ITA) which was intended to run for five years from 1 July 1982. Under the Agreement, the ITC was authorised to establish a buffer stock of tin operated by the Buffer Stock Manager (BSM), and to require producing members to impose export controls on tin (World Bank, 1981).

[76] Marc Richie was later discovered by Mahathir to be a controversial trader and known as the "king of commodities". In the 1980s he was accused of tax evasion, fraud, as well as illegal trade with Iran and fled to Switzerland. Mr Richie remained on the FBI's Most Wanted List for almost two decades, narrowly escaping capture in Finland, Germany, Britain and Jamaica (BBC News, 2013) .

[77] Translated at USD1 to RM2.1 in 1981

the LME allowed speculation and short selling, which gave rise to gambling and deliberate manipulation. The experience also created a scandalous impact in the Mahathir administration and perpetually altered his sentiments towards Western nations.

Mahathir (2011) explains that he had become sceptical of any individual or organisation from Western countries and doubted their true intentions. He became pro-Japan more than any other Southeast Asia leader in terms of foreign policy, where he had originated the ‘Look East’ policy as well as ‘East Asian Economic Caucus’ (EAEC). Mahathir believes that Malaysia and Japan have more similarities in their culture and pushed for the Look East policy in pursuit of Japan’s industrialisation policies and structure. Additionally, the EAEC was meant at forming a Japan-led regional economic alliances to deal with other more advanced western economic alliance, such as the EU and NAFTA.

6.2 The potential effects of IMF intervention on the NEP

In Malaysia, the income disparity connecting the Muslim Malays and the minority Chinese was the primary cause of social and political disputes. It was one of the major aspects that policy makers had to seriously consider. *Bumiputera*[78] was about 60% of the overall population, but the wealth and economy were dominated by the Chinese. The 13 May 1969 ethnic riots had terrified political leaders and they collectively agreed that the economic disparity between the ethnic groups was a destabilising element. Consequently, a political coalition consisting of multi-ethnic political parties achieved an understanding that non-Malays should accept policies in favour of Malays to prevent further ethnic conflicts. The non-Malays had deemed it as an insurance in safeguarding them a protected business environment. The NEP gave special preference to the Malays in order to reach an equitable economic development among the various ethnic groups with the objective in narrowing the gap of the inter-ethnic income inequality.

In his speech in Northbrook, USA on 1 September 2000 titled "Malaysia's Experience - Lessons for the *Ummah*" (Mahathir, 2000a), he clarified that “In the case of Malaysia, the Ringgit is devalued by 20%...this means is that we have lost 20 percent of the purchasing

[78] The literal meaning of Bumiputera is “sons of the soil”.

power of whatever money we have. The poor have become poorer and there are now more poor people in Malaysia.. We implemented a number of measures to contain the downturn, but all these measures failed… Calling in the IMF would have been a disaster for the *Ummah*, as the NEP policies are not in keeping with the IMF's idea of free unfettered competition ... "

There was an undeniable pressure between the NEP conventions and neoliberalism, one which upheld the balance between ethnic fairness and economic progress versus one that promotes economic performance. Due to this mounting pressure, the policymakers had split into two teams i.e. Mahathir's team versus his deputy, Anwar who was also the Finance Minister. While Anwar's allies which included leaders from BNM and the Treasury favoured the conformist policy measures, Mahathir's disciples stood by the doctrine of the NEP.

However, it was the consortium of *Bumiputera* business owners that eventually swayed the stroke of the pendulum towards the NEP. The consortium had exceedingly defied Anwar's policies as the policies resulted in the termination of mega projects and escalating interest rates, which had damaging effects on their business ventures. Naturally, Mahathir capitalised on this dissatisfaction to preserve his political power and to prevent bankruptcy proceedings for some of his cohorts. In spite of this, it appeared to the public that Mahathir and Anwar had a good relationship as both leaders dismissed any conflict between them as a groundless rumour. This perception was further validated when Mahathir appointed Anwar as the acting Prime Minister and the stand-in UMNO president when he took a 2-month leave abroad in 1997, convincing the public of Anwar's succession (Chin, 2000).

Even though Mahathir had blamed the financial crisis on external sources, the Panic of 1997 had raised considerable questions over the measures of the Washington consensus. Anwar's policies had heightened the strain between the country's economic performance and social aspiration of the communities. Undeniably the contagion effect of the Thai crisis led the Ringgit into a downward spiral, and hedge fund managers initiated a streak of speculative attacks on Malaysia's Ringgit in hope of a massive devaluation. Accordingly, interest rates for the offshore Ringgit escalated higher than the internal domestic rates that produced a nasty series of substantial capital flights out of the country and severe financial pressure. Mahathir's strong criticism against hedge funds managers indicated a potential policy shift when he blamed George Soros of attacking and disrupting the currency markets during his speech in Hong Kong. Mahathir argued that "The currency traders have become rich, very very rich through making other people poorer...And when they are annoyed, they can reduce us to basket cases... They will determine we prosper or don't... Currency trading is unnecessary, unproductive and immoral. It should be stopped. It should be made illegal... If trade is to grow, then currency values must be linked to the economic performance of the countries concerned" (Mahathir, 1997a).

Control on capital accounts were tipped as a policy option in early 1998, but not all policy makers supported them. The BNM governor and his deputy had opposed the policy as they were worried that it would cut off Malaysia from the global finance community. Due to their disagreement, it took several months in the implementation of the capitals control as the central bank's role was crucial in carrying out this policy (*The New York Times*, 1998). Doraisami (2005b) claims that the implementation of the NEP in 1970 and the drive for liberalisation and privatisation were critical factors in influencing the decision for capital control implementation in managing the Panic of 1997. Her study focus on the political economy of capital flows and capital control in Malaysia and argues that the ultimate goal of the NEP must be uphold at any cost. NEP is aimed at fostering national unity via eradication of poverty and to restructure society in order to eliminate the identification of race with economic function and geographic location. When the Panic of 1997 began in Thailand, Malaysia's economic fundamentals were relatively strong in comparison to its neighbouring countries. External forces and currency speculators were identified as the cause of the Panic of 1997.

Additional measures were introduced mid-1998 by Malaysian authorities, including the monetary and fiscal policy. Stemming from the concern of the escalating crisis in the financial market, the central bank cut down the statutory rate and the 2-month Kuala Lumpur interbank rate. Two debt resolution agencies, a national fund and an asset management company were established to recapitalise ailing banks and absorbed bad debts. Doraisami (2005b) argues that the corporate restructuring undertaken as part of the crisis management had political implications for the elite ruling party, UMNO. She further claims that most of the UMNO-linked businesses were badly hit by the Crisis and this weakened the position of the incumbent Prime Minister, as the President of UMNO. Doraisami concludes that the decision for capital controls as a crisis resolution strategy was likely to be centred on political pragmatism rather than economic necessity. On the other hand, Yasin (1994) argues that the Islamisation strategy to a certain extent contributed to Malaysia's economic development and the creation of two important Islamic institutions: the first Islamic bank and a Pilgrimage Fund. Yasin examines the role of Shariah or Islamic law on the policy making the effects of the economic development of Malaysia from the historical event in 1969 that sparked the formulation of the NEP, up to the pinnacle of Malaysia's economic development in 1993.

The argument by Yasin (1994) is supported by Pramanik (2002) demonstrating the link between progress and Islam, rejecting the worldview misconceptions created by Western scholars on the compatibility between Islam and development, using Malaysia as a case study. Malaysia's establishment of the NEP had a two-pronged objective of eliminating poverty and restructuring society to ensure economic and social fairness for the less fortunate ethnic community in Malaysia. Pramanik argues that the NEP is based on one of the most essential principles of fairness and its implementation had set the foundation for a modern Malaysian society for all races. However, Pramanik (2002) also highlights that the NEP had a number of drawbacks. Pramanik and Gomez and Jomo (1998a; 1999; 2004b) suggest 'that implementation of NEP hindered economic growth'. They argue that if Malaysia's economic growth was not hampered by NEP, the economic standing and social welfare of the underprivileged race would have been elevated to a higher level. But their arguments lack the support of any empirical evidence. Similar to Yasin (1994), Pramanik (2002) concluded that the successful implementation of NEP enabled the country to achieve rapid growth as it had given the majority Malaysia population the opportunity to progress and attain the goal of sustaining a quality life, raising future offspring, safeguarding individual faith and enjoying rewards of individual efforts. The success of the NEP is evident through the establishment of supporting institutions for the less privileged community, mainly in education, finance and business.

Table 6.1: Mean monthly household income by ethnic group and stratum, Peninsular Malaysia, 1970–2002 (RM)

	1970	1973	1976	1979	1984	1987	1990	1995	1999	2002
Total	423	502	566	669	792	760	1,167	2,020	2,472	3,011
Bumiputera (B)	276	335	380	475	616	614	940	1,604	1,984	2,376
Chinese (C)	632	739	866	906	1,086	1,012	1,631	2,890	3,456	4,279
Indian (I)	478	565	592	730	791	771	1,209	2,140	2,702	3,044
Other	1,304	1,798	1,395	1,816	1,775	2,043	955	1,284	1,371	2,165
Urban (U)	687	789	913	942	1,114	1,039	1,617	2,589	3,103	3,652
Rural (R)	321	374	431	531	596	604	951	1,326	1,718	1,729
Disparity ratio (C/B)	2.29	2.21	2.28	1.91	1.76	1.65	1.74	1.80	1.74	1.80
Disparity ratio (I/B)	1.73	1.69	1.56	1.54	1.28	1.26	1.29	1.33	1.36	1.28
Disparity ratio (U/R)	2.14	2.11	2.12	1.77	1.87	1.72	1.70	1.95	1.81	2.11

Note: The figures shown for 1970 to 1987 are in constant 1978 prices, and the figures shown for 1990 to 1999 are in constant 1990 prices.
Source: Government of Malaysia 1981, 1989, 1996, 2001b, 2003 as adapted in Jomo (2004b)

6.3 Financial Developments before the Panic of 1997

The Malaysian financial system has exhibited many features of the 'Anglo-Saxon model', being a former British colony and greatly influenced by financial trends in the U.S. and U.K, restricting banking activities to accepting deposits, granting loans and other specified banking activities. Banks in Malaysia are kept at arm's length from involvement in corporate governance and management. Shares held by a commercial bank in manufacturing companies should not exceed 10% of the paid-up capital and reserves of 5% of a foreign bank's net working funds, whichever is lower (BNM, 1999c).

Malaysian banks also tend to be conservative, mainly extending loans on the basis of collateral, rather than project viability. 'These policies … impose on industry a similarly cautious and short-term view of investment, profitability and profit allocation and inhibit long-term or high-risk industrial investment' (Hing, 1987). The lack of any motivation for Malaysian bankers to support long-term lending for constructive investments was one reason for the limited development of the country's manufacturing proficiencies, especially in non-resource-based export-oriented industries (Jomo, 1998b). Export-oriented manufacturing only accounted for a minor percentage of total outstanding loans given by commercial banks. There is minimal indication of any financial strategy serving as an important tool of industrial policy in Malaysia, apart from export credit and some relatively minor financial institutions (Jomo, 1998b). Just over 25% of Malaysian commercial bank financing goes to manufacturing, agriculture, mining and other productive activities, and the percentage is likely to be even smaller with foreign borrowings, most of which have been collateralised with assets such as real property and stocks. Hence, despite considerable government intervention in the financial sector, more than 70% of bank loans in Malaysia were not for productive investments in manufacturing, agriculture and mining, but for other purposes, especially real property and share purchases and consumption credit (Jomo, 1998b).

In the mid-90s, just before the Panic of 1997, BNM began trying to consolidate Malaysian banks, in anticipation of further financial liberalisation an introduced a new 2-tier regulatory system in December 1994. The new system sought to provide incentives for smaller banks to consider recapitalisation or a merger exercise. Banks must have an equity base of at least RM500 million (USD131 million) to qualify for tier-one status[79]. The origins of the Panic of 1997 can be tracked to fragmentary and inappropriately sequenced liberalisation of the Malaysian financial system; after all, 'in a deregulated, liberal environment, banks are prone to speculate or lend excessively in areas such as in real estate, stocks or commodities' (Park, 1996). Prudent regulation by the government is necessary to help maintain a balance between the competitive efficiency of markets and the safety of the banking system (Islam and Chowdhury, 1993). Appropriately planned deregulation as well as persistent regulation of the capital account to restrain exit may have been able to alleviate some damaging excesses which contributed to the recent financial crises in Malaysia and Southeast Asia (Randhawa, 2011).

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[79] Tier-one banks have the exclusive privilege to handle certain lucrative kinds of transactions denied to other banks, such as opening foreign currency accounts.

The International Finance Corporation (IFC), a World Bank subsidiary had promoted the stock markets globally, which resulted in the increasing significance of equity finance and stock markets in the Southeast Asia region, especially in Malaysia, with its British colonial heritage (Jomo, 1998b). The successful promotion by IFC had been accompanied by considerable financial disintermediation from the banking system to the securities markets, particularly in the bull-run years of the early 1990s. In June 1995, the Finance Minister announced a package of incentives to attract foreign fund managers to Malaysia, thus further liberalising the capital market for foreign financial institutions (Athukorala, 1998). This promotion had made the Malaysian economy more susceptible to both global macro-economic instabilities and capital flight, and made the tasks of currency exchange and inflation control more challenging (Jomo, 2001a).

Malaysia's economic condition preceding to the Panic of 1997 appeared strong in many respects. Its macroeconomic indicators had shown strong growth with the declining current account deficit (Berg, 1999). The banking sector appeared robust, with projected NPLs decreasing from 20% of total loans in 1990 to under 4% in 1996 (BNM, 1999c). Berg's analysis for the IMF report (1999) showed that the capital adequacy ratios in the banking system appeared high, while the supervisory and regulatory framework was generally deemed strong. Additionally, there was little dependence on foreign capital, particularly, short-term flows, with strict controls on short-term borrowing, net foreign exchange positions of banks, and off-balance-sheet activities.

Nonetheless, there were some important warning signs as the current account deficit was in excess of 5% of GDP, exports had decelerated, in large part due to falling foreign demand and some real appreciation of the Malaysia Ringgit, though also because of increased competitive pressures from China (Wade, 1998b). However, domestic credit growth remained sound, particularly in the consumption and property sectors. While property prices were fairly stable, there were concerns that a coming surge of supply could depress prices, particularly in an economic downturn. After the Thai devaluation, the Ringgit came under strong pressure and was floated, after brief interest rate defenses and some intervention, on 14 July 1997 (Berg, 1999).

6.4 The Panic of 1997

After the involuntary devaluation of Thailand's baht on 2 July 1997, the credit crisis spread quickly through the region. There was a sudden collapse in the confidence in the Asian currencies worsened by dramatic devaluation (Jomo, 1998). As a result, overseas lenders withdrew their short-term loans and the affected countries were not able to roll over their debt. On 11 August 1997, the IMF unveiled a rescue package for Thailand worth more than USD17 billion and approved another bailout package worth USD3.9 billion just 9 days later (Wade, 1998a). As the Panic of 1997 intensified, earlier commendation for the economic strategies of the region were no longer applaud - the "miracle" framework in Southeast and East Asia, repeatedly inscribed as models, was criticised for all the turmoil. "The attachment to the family becomes nepotism. The importance of personal relationships rather than formal legality becomes cronyism. Consensus becomes wheel-greasing and corrupt politics. Conservatism and respect for authority become rigidity and an inability to innovate. Much-vaunted educational achievements become rote-learning and a refusal to question those in authority" (*The Economist; London*, 1998).

Another factor is the dismantling of capital controls in the process of the deregulation of the Asian economies. Even though the Asian countries had been reluctant to dismantle capital controls, in the 1990s these controls where lessened in order to increase the efficiency of the financial system and welcome financialisation. According to Wade (1998a) financialisation was unveiled in Southeast Asia when the IMF and World Bank had urged the Asian governments to liberalise their financial system through the 1990s, including their external capital account, which allowed domestic agents to raise funds via the foreign markets while it also permitted access to the domestic markets by foreign agents.

This view was supported by Jomo (1998) and Wade (2003), who viewed that the Panic of 1997 was induced by IMF's encouragement of Southeast Asia's financial markets to open up to large inflows of bank borrowings and portfolio investments, which later flowed out even more rapidly, causing the currency collapses and financial panics that brought the region down. Wade, Jomo and Ariyoshi (1998; 2000; 2001a) argued that opening of capital account and liberalisation is risky when domestic banks and companies have insufficient understanding of the international financial markets. Wade et al. (1998) further stated that with the wisdom of hindsight, the increased efficiency by the lowering of interest rates for domestic borrowers, was at the expense of intensifying instability and escalating volatility. In addition, Asian countries economic policy makers miscalculated the perils of global financial markets and were distracted by their accomplishments with industrial products. Cheap short-term debts were utilised to fund long-term investments.

The Panic of 1997 had resulted in severe hardship to most people in Malaysia. Not only had it reduced the demand for labour but also increased the rate of unemployment as well as lower wages. This Crisis prompted the government to introduce a reform programme, which aimed to mitigate the impact of the economic slowdown on low-income groups. Specifically, the government maintained a high level of spending on health, education and improved quality of human resources (World Bank, 2017c).

6.5 Early Policy Responses

An early series of policy measures by the Mahathir administration were adopted to deal with the financial crisis and stabilise the economy. The 1998 Budget contained measures to reduce the current account deficit, strengthen balance of payments and fiscal account, improve competitiveness, and increase monetary and financial stability. The 1998 Budget announced on 17 October 1997 encompassed the following measures:

i) Reduction of Federal Government expenditure by 2%, deferment of mega projects, and review of public agencies purchases of foreign goods.

ii) On the financial aspect, the prudential standards were strengthened with the classification of non-performing loans in arrears from six to three months, greater financial disclosure by banking institutions, and increasing general provision to 1.5%.

iii) The Credit Plan was introduced to limit overall credit growth to 25% by the end of 1997 and 15% by the end of 1998. In providing loans, banking institutions were to give priority to productive and export-oriented activities.

The financial crisis presented Anwar the chance to contest Mahathir's leadership as there was strong criticism against Mahathir's proposed policy responses to the Crisis. At the same time, President Suharto's ignominious downfall affected Mahathir's power because there were several resemblances between the two leaders[80]. This strained relationship appeared to emerge when Anwar revealed a distinct economic package on 5 December 1997 (Johnson, 1998). The policies were as follows:

i) Reduce the current account deficit to 3% of GNP in 1998.

ii) Trim Federal Government expenditure by 18% in 1998.

iii) Stricter criteria for approvals of new reverse investment and defer the implementation of non-strategic and non-essential projects.

iv) More emphasis placed on good corporate governance.

In February 1998, Anwar announced the additional measures:

i) BNM's three-month intervention rate was raised from 10% to 11%.

ii) The statutory reserve requirement (SRR) reduced by 3.5% of eligible liabilities to 10%.

According to Anwar, the additional economic package was needed as the regional instability proved to be more protracted than earlier anticipated. Anwar's policy measures were aimed at strengthening economic stability and instilling confidence in the financial system. There were concerns about the large current account deficit and high private sector debt amounting to 160% of GDP in 1997. Hence, there was a need to prudently manage public sector finances while curbing excesses in the private sector.

The foreign financial community had applauded Anwar's policy package and the praise from managing director of IMF, Michel Camdessus validated Anwar's policy decision. This support reassured Anwar to somewhat distance himself from Mahathir's initial policy responses and Anwar had boldly declared that Malaysia's quest for progress lacking of democracy could promote corruption and cronyism. Anwar's statement was an implied defiance to Mahathir, and Mahathir's conviction that Malaysia's progress should be accomplished without modification to the current policy framework (Hilley, 2001).

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[80] Both leaders were known for intolerance of dissent and cronyism (Backman, 1998).

Anwar's economic package had defied Mahathir politically in two aspects. First, some of Mahathir's mega projects were suspended following tightening of the 1998 Budget, such as key infrastructure projects like the Hydro-dam in Bakun, the International Airport in the Northern Region, the Kuala Lumpur Linear City, and the second phase of Putrajaya, the current administrative hub. Second, it was introduced by BNM and the Treasury, without the full blessing from Mahathir. When some initial measures initiated by Mahathir fail to work and worsened the financial condition,[81] Anwar had taken the opportunity to put forward his ideas into the economic policy. His main concern was to renew foreign investor assurance, which meant adhering to the IMF-design macroeconomic policy. Despite the global recognition of his method, among senior policymakers only the BNM governor backed Anwar.

Even with the validation from IMF, Anwar's policy proposal was not capable in reinforcing any influence of neoliberalism into the government. Firstly, the *Bumiputera* commercial society supported Mahathir's analysis of the situation as the *Bumiputera* companies anticipated government financial aid as forthcoming. Secondly, Malaysia's financial position was relatively stronger than its neighbours as it short-term foreign loans were comparatively smaller. This had made it possible for Malaysia to endure the impact of the Panic of 1997 in the first few months since the contagion began, avoiding any external funding. Yet, the substantial wave of capital outflows had necessitated the Malaysian government to pursue additional financial restructuring.

Just before the regional currencies crisis, Camdessus had praised the BNM for a well-managed economy and financial system at the Los Angeles World Affairs Council, (New Straits Times, 1997), "Malaysia is a good example of a country where the authorities are well aware of the challenges of managing the pressures that result from high growth and maintaining a sound financial system amid substantial capital flows and a booming property market." Camdessus (1997) also commented that inflation was low and the

[81] This included the stock markets interventions and the rescue of UMNO-linked Renong.

Ringgit[82] was a strong currency, an indication of a sound economy. However, there were still powerful sentiments on the possibility of financial contagion.

Prior to the Crisis in early May 1997, Mahathir took a 2-month leave as he planned to hand over his premiership to Anwar and left his deputy in charge as the acting Prime Minister. Anwar was also the Minister of Finance at that time and had frequent meetings with the IMF. Based on this knowledge, when the Thai baht was attacked in July 1997, Mahathir had asked Anwar to appeal to Camdessus for IMF to intervene on the currency trading that was affecting the Asian countries, but no attempt was taken by the IMF. Mahathir was unsure if Anwar had relayed his message to the IMF, or whether the IMF had ignored their request. Mahathir had also written to the French President, Jacques Chirac and British Prime Minister, Tony Blair for support to request the IMF to intercede on the currency trading, but to no avail.

Subsequently, Mahathir had continuously criticised the currency traders for creating financial disorder in the Southeast Asia market and IMF for its lack of intervention. The first international condemnation was in Hong Kong in September 1997 (as mentioned above) and then again in Chile, and with each criticism the Ringgit worsened. Mahathir argued that since the reaction was instantaneous, it could not have been market reaction. He believed that currency traders had been pushing for the devaluation of the Ringgit. Anwar on the other hand was in support of the IMF and its proposed solution. As the Finance Minister, he raised interest rates and cut back on government spending. Anwar believed that even though Malaysia did not have to borrow from the IMF to settle foreign debts, it still had to accept the advice from IMF. Conversely, Mahathir believed that since Malaysia's foreign debt was comparatively small as compared to other crisis-affected countries as depicted in Table 6.2, the country could respond to the Panic of 1997 without any help from the IMF.

82 Ringgit remained to be at an average of RM2.50 to USD1 for more than 5 years (https://www.ceicdata.com/en/indicator/malaysia)

Table 6.2: Lending by BIS Reporting Banks - End June 1997

USD Millions	Total	Banks		Public Sector		Private Sector	
Malaysia	28,797	10,486	*36%*	1,851	*7%*	16,460	*57%*
Indonesia	58,641	12,393	*21%*	6,506	*11%*	39,742	*68%*
South Korea	103,360	67,290	*65%*	4,390	*4%*	31,680	*31%*
Philippines	14,112	5,485	*39%*	1,855	*13%*	6,772	*48%*
Thailand	69,299	26,069	*38%*	1,968	*3%*	41,262	*60%*

Source: Bank of International Settlement as adapted in Jomo (1998c, p. xv)

Anwar had agree with IMF and made another bold move to reduce the default payment period form 6 months to 3 months before declaring loans as NPL. This resulted in banks with a much higher NPLs, while worsening the default rates and consequently slowing down the economy[83]. Disagreements on responses to the Crisis was the beginning of the conflict between Mahathir and Anwar, which eventually had a significant impact on the political landscape of Malaysia and the subsequent policy responses to the Panic of 1997.

In opposition to Mahathir, Anwar had suggested that it was improper to attribute the reasons of the Panic of 1997 entirely to foreign elements since Malaysia had deficiencies in its financial system (Jomo, 2006). Anwar announced the IMF policy proposals in December 1997, justifying his approach on economic productivity. Anwar believed this method would attain external investor assurance in the short term and strengthen institutional structures for better economic improvement in the longer term. However, this also entailed the principles of the NEP to be revoked. It is difficult to interpret why Anwar accepted the pro-IMF stand because his constituents who were mainly from the poor rural region, would be the most badly affected from the adoption of the IMF approach. Consequently, "Anwar's choice portrayed him as pro-West and principally with regard to the frameworks of public rhetoric that had previously been formed" (Chin, 2000). Prior to the Crisis, Anwar had won countrywide fame as a guardian of Muslim Malays. He was also known for his strong criticism on Western lifestyle in defence of

[83] The issue of NPLs and financial restructuring are further analysed in Chapter 5.

Islamic values and culture. Henceforth, the sudden transformation in his support of pro-Western ideals had exposed his true political ambitions.

6.6 Developing the Malaysian Alternative Strategy

It was during his holiday in England that Mahathir first heard the news of the attack on the Thai baht. In August 1997, Malaysia had decided to help fund Thailand's rescue package so that Thailand could strengthen its reserves[84]. Mahathir was convinced at that time that the Malaysian finances were sound, as neither the government nor the business community needed to borrow much of foreign currencies. Malaysia's interest rate had always been low and foreign currency borrowings would not give Malaysia any advantages. At the World Economic Forum in October 1999, he stated, "We believed in mid-1997 that we were not like Mexico, not like Thailand. We had no massive foreign debts, neither the Government nor the private sector. We had no difficulty whatsoever in quickly pledging one billion US Dollar to help Thailand and one billion US Dollar to help Indonesia. We believed that our economic fundamentals were exceedingly strong. In fact, in the middle of June 1997, Mr Michel Camdessus himself had described in open forum and in detail the great fundamental strengths of the Malaysian economy" (Mahathir, 1999).

When both the real and financial economy worsened, Mahathir's government chose to adopt an alternative economic policy. This new policy was implemented phase by phase and piece by piece as the economy progressed. Despite the differences in opinion, both Mahathir and Anwar had agreed to set-up an economic task force, which consisted of selected members of the Cabinet, business leaders and economic specialists, to enhance disclosure of information of corporations and closer scrutiny for corporate restructuring. The task force, known as the NEAC was setup to take over the management of the economic crisis. The purpose of the NEAC is to provide "concrete proposals to the

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[84] The IMF alone would not be able to raise the full amount needed. Prospective bilateral donors, meeting in Tokyo on August 11, 1997 chipped in. The IMF contributed USD4 billion, and the government of Japan contributed an equivalent amount. The World Bank and the Asian Development Bank pledged USD1.5 billion and USD1.2 billion, respectively. The governments of Australia, China, Hong Kong, Malaysia, and Singapore all pledged at the USD1 billion level. Indonesia and the Republic of Korea each pledged USD0.5 billion (World Bank, 2001, p. 26).

government to halt the deteriorating economic condition and revitalise the country's economy". The NEAC's primary task was to draw up the NERP that would steer the country out of the Panic of 1997 and towards economic revival. The government via the NERP introduced both short and long term tasks to deal in lessening the effect of the contagion.

Specifically, to work on the capital control measures, Mahathir decided that he needed someone who understood the global financial system well, with the relevant experience. As a result, Mahathir chose Nor Mohamed Yakcop[85], because he knew that Nor was the head of BNM currency trading operation during BNM's involvement in the tin trading at the LME. The engineer for the capital control policy was Nor, who designed the framework and implementation of the policy. Nor was also unconvinced of the "financial liberalisation" and believed that neo-liberalism was more effective to industrialised countries in the West than developing countries in the East (Raj, 2002), a view that was consistent to Mahathir rather than Anwar.[86] Nor was later invited to be a member of the NEAC.

NEAC was set up to address the financial crisis situation in Malaysia and consisted of 27 members with Mahathir as the Chairman.[87] Based on the research by Wong (2011), it took Mahathir and his unofficial economic advisor, Nor Mohamed eleven months to convince the NEAC to accept the NERP. The other members of the NEAC were exceedingly sceptical on the success of the plan, particularly on the part of implementing the capital controls (Wong, 2011). Throughout the planning stage, Mahathir (2011) was insistent on two issues:

i) That Malaysian businesses should not be allowed to close down to protect jobs; and

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[85] Prior to August 1998, Nor Mohamed Yakcop initially became the unofficial advisor to Mahathir. He was then appointed as the special economic adviser to the Prime Minister.

[86] Anwar Ibrahim was the Deputy Prime Minister cum the Finance Minister during the Panic of 1997.

[87] Mahathir also chaired the executive committee of the NEAC, and they met every morning except on Wednesdays to make way for Cabinet and Sundays.

ii) Malaysia must never go to the IMF. He realised that by accepting IMF's rescue package would mean that Malaysia will have to abandon the NEP, and this may have adverse social consequences.

Originally, Anwar and his Finance Ministry led the management of the Crisis but with the creation of the NEAC, the core decision-making authority was transferred to the Prime Minister's Department. Mahathir (2011) mentioned that on the onset of the Crisis, he was not familiar with the international monetary system and had sought the advice from his financial advisors in the government, mainly from the MoF. Mahathir later discovered that the measures undertaken were ineffective as his advisors did not fully understand the intricacies of the international financial system. Mahathir also stated in his memoir (Mahathir, 2011) that he initially could not figure out how such a large sum of currencies could leave Malaysia undetected and how currency traders could physically handle billions of Ringgit, and none of his financial advisors could fully explain the situation to him. This fact was also another reason for the setting up of the NEAC.

The NEAC was chaired by Mahathir and comprised several core Ministers, state government officials, government agencies business delegates and non-government bodies. It functioned and had the authority similar to an emergency cabinet (Khor, 2008). It had an executive committee chaired by Mahathir, a secretariat[88] and supported by a working group of 5 representatives gathered from industry and academia. The formation of this strong-powered council with overriding power to handle the Crisis on an emergency basis, was a fundamental form of the Malaysian framework of crisis control. Ultimately, it was the NEAC that originated an alternative medium-term action plan to manage the Crisis, with intensive monitoring of all aspects of the economic condition. The executive committee met a few hours daily to collect responses on implementation as well as impacts of the action plan (Mahathir, 2011). The NEAC also managed to steer clear of the customary protectionism between different Ministries and decisions were reached in an organised and efficient manner.

88 The secretariat was set up in the Prime Minister's Office, with an Executive Director and round-the-clock staff drawn primarily from the EPU.

The series of the alternative Malaysian plan took several stages:

1. After NEAC's formation in January 1998, its executive committee, secretariat and working group undertook a comprehensive discussion over several months with delegates of various segments, to figure out their issues and receive their opinions and policy propositions.

2. The NERP was drafted and announced on 23 July 1998. The objectives of NERP and the proposed measures are summarised in Table 6.4 below, which included a fresh approach to fiscal and monetary policy. Its implementation also involved organisational concerns, involving restructuring of corporate debt banking sector recapitalisation whilst dealing the NPLs. Various actions were carried out from the start to the midst of 1998 to repeal the contractionary policies that were initiated in the end of 1997.

3. On 1 September 1998, action plans were revealed by Mahathir on the currency and the movement of capital, summarised as below:

   i) Stabilisation of the Ringgit via fixing the exchange rate at RM3.80 to the US dollar;

   ii) Prohibiting foreign speculation on the value of the Ringgit and Malaysia stock market by regulating the foreign trade and immobilising the external Ringgit accounts of non-residents in Malaysia. This was targeted at phasing out the Singapore offshore Ringgit market and preventing currency traders from gaining access to Ringgit funds; and

   iii) Lessening capital outflows via selective measures of capital controls, as tabulated in Table 6.3 below.

Table 6.3: Selective Exchange Controls during the Panic of 1997

Transaction subject to control	Transaction not subject to control
Ringgit-denominated transactions with non-residents	Current account transactions • trade transactions denominated in foreign currency
Outflow of short-term capital • One-year withholding period until 30 August 1998 • A three-tier tax (10%, 20%, 30%) on profit remittance between September 1998 and February 1999	Repatriation of profits, interests, dividends, capital gains and rental income from FDI and similar forms of ringgit assets owned by non-residents
Import and export of ringgit (carriage on person)	
Export of foreign currency by citizens (carriage on person)	General payments by residents including those for education abroad
Outflow of Malaysian investment abroad	FDI inflows and outflows

Source: BNM Annual Report Box 8.5 (1999c, p. 293)

The controls were confined to short-term capital flows with the purpose of making it difficult for short-term portfolio investors to sell their shares and keep the proceeds and for hedge fund managers to drive down the currency. No controls were imposed on long term commitment to an open trade and investment policy. The policy was created to prevent capital outflows instead of capital inflows.

Mahathir said that when the world turned away from the Bretton Woods fixed exchange system, it assumed the floating rate system was a better way to evaluate currencies (Stiglitz, Ocampo and Ocampo, 2008) . "But the market is now abused by currency traders who regard currencies as commodities which they trade in. They buy and sell currencies according to their own system and make profits from it, but they cause poverty and damage to whole nations. That is very regressive, and the world is not moving ahead but backwards" (Bello et al., 2000; Stiglitz, Ocampo and Ocampo, 2008).

Table 6.3: Summary of Capital and Exchange Control Measures in 1997–99[89]

Measure	Motivation
4 August 1997 - Controls were placed on banks to reduce outstanding non-commercial related Ringgit offer-side swap contracts to USD2 million per non domestic customer	To delink the offshore Ringgit market from its onshore counterpart and cut down domestic onshore interest rates.
1 September 1998 – Introduction of a selection of exchange control measures: • Repatriation of Ringgit offshore funds will require BNM approval. • Limit on exports and imports of Ringgit. • Residents not allowed to give loans non-resident banks and stockbroking firms. • Residents not allowed to obtain Ringgit loan from non-residents. • Settlement of all imports and exports to be in foreign currency. • Domestic banks were not allowed to conduct transactions in offer-side swaps with non-resident banks. • All purchases and sales of Ringgit financial assets can only be transacted through authorised depository institutions.	Intended to eliminate the offshore Ringgit market and reducing the supply of Ringgit for speculations
1 September 1998 – Introduction of extra measures : • Approval requirement for non-residents to convert the Ringgit held in external accounts into foreign currency, except for purchases of Ringgit assets. • A 12-month waiting period for non-residents to convert Ringgit proceeds from the sale of Malaysian securities held in external accounts. • Approval requirement beyond a certain limit for all residents to invest abroad in any form.	Intended to prevent heavy capital outflows by residents and non-residents.

[89] For further details, refer Appendix II.

Measure	Motivation
• A specific limit on exports of foreign currency by residents and up to the amount brought into Malaysia for nonresidents	
15 February 1999 - The 12-month holding period rule for improvement of portfolio investment was substituted with exit levy system.	To encourage new funds/investors to the country.
18 February 1999 and 5 April 1999 - Property investments and investors in MESDAQ were exempted from the exit levy.	Exemption of investments that resemble FDI.

Source: Ariyoshi *et al*. (2000, p. 98).

6.6.1. The NERP

The NERP comprised approximately 580 detailed instructions, including broad-ranging plans for economic equilibrium and fundamental restructurings while tackling socio-economic agreements and regions distressed by the Crisis. Launched as a consulting body to the cabinet, the NEAC presented the broad framework of crisis control. Its primary task was to deliver a thorough framework and the coordination of the relevant ministries at the point of execution.

Table 6.4: Summary of NERP

Objectives	Measures
Stabilising the Ringgit	• Appropriate Choice of Exchange Rate Regime • Reduce Over-Dependence on the US Dollar • Increase External Reserves • Adopt a Balanced Interest Rate Policy
Restoring market confidence	• Improve Transparency and Regulatory Environment • Establish Rules for Assisting Industries and Companies in Trouble • Increase Consistency of Policies • Adopt Liberal and Market-Based Policies • Improve Public Relations • Improve the Dissemination of Economic Information

Objectives	Measures
Maintaining financial market stability	• Preserve the Integrity of the Banking System • Establish Agencies Along the Lines of FDIC/RTC • Recapitalise the Banking Sector • Monitor Closely Overall Credit Expansion • Improve the Capital Market • Develop the PDS Market
Strengthening economic fundamentals	• Increase the Quality of Investments • Improve the Balance of Payments • Maintain a Balanced Public Sector Financial Position • Maintain an Appropriate Monetary Policy • Maintain Price Stability • Increase Labour Competitiveness
Continuing the equity and socioeconomic agenda	• Ameliorate the Hardship from Poverty • Address the issues on *Bumiputera* Equity Ownership • Expand Employment Opportunities • Meet the Challenge of Expanding Tertiary Education • Address the Problem of Graduate Unemployment • Control the influx of Foreign Workers • Gear up State Corporations to Face the Crisis • Revamp Cooperatives and Cooperative Banks • Protect the Environment for Sustainable Development
Restoring adversely affected sectors	• Primary Commodities & Resource-Based Industries • Information Technology & Multimedia Super Corridor • Insurance and Reinsurance • Industrial Development Finance Institutions • Freight Forwarding • Infrastructure • Manufacturing • Transportation • Tourism • Construction • Property

Source: NEAC (1998)

The setting up of the NEAC from a political standpoint indicated a cause of concern as it revealed a widening rift between Mahathir and Anwar. Apart from the appointment of Nor as the advisor on capital controls measure, Mahathir had also appointed his close ally and former finance minister, Daim Zainuddin[90] to play a lead role in the NEAC as its director. Daim was considered a politician who was candid in his support for the NEP principles. Therefore, Daim was not in favour of Anwar's pro-IMF policies and argued that these policies would weaken the economic position as well as political dominance of the *Bumiputera*. The raising animosity between the NEAC and Ministry of Finance had interfered in a cohesive policymaking procedure.

From a fiscal perspective, Malaysia was cautious, and the economy recorded a considerable fiscal surplus for a continuous five years (1992-97). Hence, it was expected that the 1998 budget would show a further surplus of 2.7%, which was planned to be revealed in October 1997. As Finance Minister, Anwar believed that current account deficits must be reduced, and the original plan must be adjusted accordingly. Anwar revealed a revised budget proposal in December 1997 to indicate Malaysia's pledge to a comprehensive macroeconomic administration. The 1998 budget featured an 18% cut in the fund allocations and as a result key infrastructure projects were either postponed or withdrawn, and public sector operational overheads were slashed. The cabinet members and senior public servants accepted a voluntary 10% and 3% pay cut respectively, in the effort to downsizing of government operations.

In short, Anwar's policy proposals was akin to IMF-back package i.e. cuts in government spending, deferring of mega projects, controlling capital outflows by increasing interest rates, and restructuring the banking sector by enhancing the regulatory framework. Retrospectively, the stringent IMF-like standpoint proved to be unsuitable. At that point, an aggressive fiscal policy was required to survive an imminent economic downturn. Malaysia's sound financial position could have given ample opportunity for anti-cyclical

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[90] Daim also acted as a "business consultant to Mahathir when he was the deputy prime minister. He was appointed a senator in 1980 and was elected to parliament in 1982. Daim assumed the role of treasurer of the UMNO in 1981. In 1984 he was appointed finance minister but continued to act as UMNO treasurer. Between 1991 and 1998 Daim was, at his own choice, out of the cabinet. He returned, at Mahathir's request, to manage the Malaysian economy throughout the Asian financial crisis of 1997–1998" (Backman, 2018).

actions. Anwar only gave in to the conservative viewpoint when Thailand and Korea intensified fiscal deficits to finance social protection and restructuring of finance system.

Some efforts were engaged to reinforce employment mobility proposals to alleviate the detrimental impact of economic stagnation. The Employment Act (1955) was revised to create further resilience to employment markets in 1998. The Crisis raised the rate of unemployment from 2.6% to 3.9% (1997 to 1998). Compared to neighbouring crisis-affected regions, its social impact on the public was moderate. Firstly, most businesses had implemented cutbacks on foreign employees rather than Malaysia citiziens. Secondly, temporary salary cuts were favoured to redundancy because the economic downturn was thought to be short term and would pass on. Therefore, labour conflict was not of primary political consideration.

The influx of substantial foreign capital in the early 1990 had warnings signal of equity and asset bubbles. On hindsight, BNM undertook pre-emptive measures to scale down the stress on inflation by introducing ceilings property borrowings and share financing. At the initial stage, BNM (BNM, 1999c, 2001b) implemented “a low interest rate strategy to safeguard highly geared companies from bankruptcy. Nevertheless, this approach was not viable due to the devaluation of the Ringgit and worsening trade deficits”. The currency devaluation made it “more challenging for BNM to follow a coherent monetary policy”. Prior to the Crisis, the Ringgit was hovering in a tight range between “2.36 and 2.51 to the USD. In March 1997, this parity became unsteady as the Ringgit devalued to an average of 2.57 in July”.

On 8 July 1997, BNM tried to stabilise the Ringgit by carrying out foreign exchange markets intervention. However, BNM gave up the intervention and let the currency devalue after losing approximately USD1.5 billion. In January 1998, the currency dropped to its deepest point at 4.88 to the USD but gradually improved in April 1998 to a level below RM4 i.e. 3.73 to the USD (IMF, 1999a). This discouraging outcome left the central bank with no option but to increase interest rates. The market-oriented approach caused severe repercussions to the economy. The majority of highly geared companies faced financial distress in serving their loan payments as interest had surged. In October 1997, for instance, Renong was compelled to undertake a debt restructuring exercise. NPL had surged due to commercial stress, which unfavourably affected the banks. In addition, fresh control measures that were meant to improve the financial system worsened the business entities.

Considering the circumstances, Mahathir requested for interest rates to be scaled down. However, Anwar ignored the Prime Minister's appeal and instead continued a high interest rate strategy on the assumption that any policy reversal would halt organisational reform as loss-making companies were allowed access to bank borrowings. The political situation in Malaysia had worsened as the dispute between Mahathir and Anwar had gone beyond economic policy. Anwar initiated a "campaign against corruption and cronyism in May 1998 and was supported by his UMNO youth members. Notwithstanding forewarnings from other senior members of UMNO, Anwar's supporters publicly requested that the government curtail cronyism" (Case, 1999). The campaign hit its greatest stage at UMNO's annual general meeting where the Youth Chief at that time, condemned the government aid given to the companies owned by Mahathir's son via the national oil company, Petronas (Jomo, 2004a).

Although the original purpose of Anwar's campaign was virtuous, the timing was more critical. At that stage, President Suharto of Indonesia was pressured to resign amid public protests. After Suharto's stepping down as Indonesia's longest-serving elected ruler, "Mahathir was expected to be concerned that the political uncertainty in a nearby country would be spreading to Malaysia" (Backman, 1998). To obtain backing from the business society, Mahathir revealed the lists of corporations and their main stakeholders that secured favourable contracts in the recent privatisation exercise (Noor, 2001). It exposed that both Anwar's and Mahathir's allies were included in the list of 300 companies. Mahathir highlighted that "the affirmative reaction was created to support *Bumiputera* business. Anwar's effort to condemn Mahathir was not effective" because his policies did not work to halt the economic downturn. On the contrary the economy weakened by a 7.4% drop of real GDP (Nasution, 2005).

Senior UMNO leaders also appeared not to support Anwar's severe policy responses, concerned about the upcoming election to be held in April 2000. Thus his confrontation with the Mahathir administration aggravated his desolation in UMNO. Mahathir seemed to be the clear winner in the tug of war even though his policies were not yet found to be appropriate and still widely open to considerable deliberation. In this regard, Anwar's loss was considered political rather than hypothetical. He failed to obtain sufficient backing to proceed with his policies even though he was backed internationally by the IMF. His supporters were gradually driven out from the cabinet, BNM and UMNO.

In June 1998, Daim's comeback to the government as a Minister with special functions, assigned with the task involving economic development verified the rumour that Mahathir had ousted Anwar from his cohort[91]. In late August, the Governor of the central bank and his deputy resigned because of their support of Anwar's policies (Lopez, 1998). It was also generally understood that Mahathir coerced two leading newspaper chief editors and a TV3 director[92] to resign, as all were considered as Anwar's allies. The last step was to remove Anwar as his Deputy and the Finance Minister in September 1998 (*BBC News*, 1998). After Anwar was sacked and the supporters of his policies were removed, policies more akin to the Keynesian approach was immediately introduced. Nevertheless, it was difficult to trigger any quick economic recovery. When the capital controls was launched, its effect on economic rehabilitation was uncertain (Goad, 1998). Capital controls on the positive side had permitted the government to reach monetary sovereignty by shielding the economy from foreign pressures. This policy was also abled to temporarily insulate Malaysia's capital market from the global financial players, which made it challenging to draw foreign funds to supports its planned structural economic reform.

Anwar had initially resisted a fiscal expansionary budget, but reconsidered the approach when the Malaysian economy weakened by 4.8% in 1H 1998. The revised budget proposal in March 1998 supported a 2.6% fiscal deficit of GDP and extra funding was allotted to social expenditure. The policy reversal resumed into 2H 1998 due to favourable external conditions. Additionally, there was demand for an extra funding for financial restructuring. An extra budget amounting to RM7.0 billion was issued in July 1998. Furthermore, a fund for Infrastructure Development was introduced to promote economic activities. Accordingly, the 1998 Budget gave rise to a 3.7% deficit of GDP.

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[91] Anti-Anwar pamphlets - *Fifty Reasons Why* Anwar Shouldn't Be Prime Minister - were widely disseminated within the UMNO.

[92] TV3 was a leading mainstream national television in Malaysia.

In terms of monetary policy, Mahathir told the NEAC to look at a low rate of interest regime in April 1998. His reason was that highly geared companies will be financially distressed and be burdened to serve their debts, rather than focusing on their core businesses. At its peak, the interest rate went up to 11% in June 1998 and he appealed to the authority to salvage some strategic companies/assets for the national and public interest. However, Anwar was steadfast with his austere policy, claiming that low rates of interest regime would promote foreign capital inflow, thereby placing further downward anxiety on the Ringgit.

The Mahathir-Anwar dispute turned sour when Singaporean banks began to dispose highly profitable Ringgit deposits[93]. The SRR was cut down from 10% to 8% from July 1998, as per Table 6.5 below. Despite the adjustment of monetary policy over the previous months, the scope for easing had been substantially constrained by concerns for possible exchange rate concerns. The imposition of exchange rates and pegging of the Ringgit immediately lifted this constraint, allowing quick adjustments instance of the policy (IMF, 1999a, p. 16).

Despite successive interest rate cuts, circulation of money did not increase. Majority of the banks were reluctant in giving out loans owing to rigid controls on NPLs. However, some controls were softened in September 1998, to promote bank lending. First, the NPL classification by banks was reversed back to the initial 6 months, rather than 3 months as imposed by Anwar's policy. Second, banks were no longer obliged to make a 20% provision on inferior loans, which had reduced the stress on their balance sheet and profitability. Finally, restructured NPLs could be re-categorised as performing loans when the instalment payments under the rearranged terms had fulfilled a 6 months period, rather than initial requirements of 12 months of uninterrupted instalments.

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[93] Unlike other regional currencies, the Ringgit was significantly traded in the region, particulary in Singapore. The substantial onshore-offshore interest rate differential attracted Ringgit funds abroad. While Malaysia had, through swap limits, curtailed Ringgit borrowings to finance currency trades, Ringgit funds were available from banks in Singapore which offered Ringgit deposit rates as high as 20-30%. While the cost of borrowing Ringgit was high, the profits on short-selling Ringgit were even higher (BNM, 1999c, p. 600).

Table 6.5: Changes to BNM Intervention Rate & Statutory Reserve Requirement

Period	Liquidity	Date	Intervention Rate (%)	SRR (%)
Jan-Feb 1998	Tightening	End-97 9 Jan 20 Jan 6 Feb	8.70 9.00 10.00 11.00	13.5
Mid Feb-July 1998	Stable	16 Feb 1 July		10 8
Aug-Dec 1998	Easing	3 Aug 10 Aug 27Aug 1 Sep 3 Sep 16 Sep 5 Oct 9 Nov	10.50 10.00 9.50 8.00 7.50 7.00	 6 4
Jan-Aug 1999	Continued Easing	5 Apr 3 May 9 Aug	6.50 6.00 5.50	

Source: BNM (1999c, p. 595)

Subsequently, based on BNM's report (1999c) the Ringgit exchange rates stabilised in the range at RM3.84-3.98 to the USD in the 1st and 2nd quarters of 1998. At this point there IMF had pressed the Asian countries to increase rates further. The IMF had proposed higher rates primarily because it projected inflation to be considerably greater in the area of 10-12%, whilst BNM only expected 7%. An agreement was reached with IMF for BNM to withstand lower rates, on the condition that BNM be prepared to increase rates immediately if attacked by currency speculators. However, BNM did not undertake this action as Malaysia chose to tolerate currency adjustment in July, succeeding the Russia's contagion effect (Stiglitz, 2002) and later enforced exchange regulations. Whereas the economic downturn signalled for easing of the monetary position, external exposures on the other hand required higher interest rates. While it's not possible to lower the interest rates, Malaysia had agreed to implement alternative steps to lessen lending rates. BNM placed RM34 billion in the market and concurrently, the SRR was lowered from 13.5% to 8% (BNM, 1999c). The rationale of the SRR reduction was to promote the liquidity circulation that had previously been injected into the banking system and to scale down the cost of funds since the SRR earned zero interest (BNM, 1999c). The funds freed by the reduction in SRR were balanced by the non-rollover of funds previously provided by BNM to banks.

Due to these actions, money market rates dropped, contributing to a reciprocal contraction in lending rates from 21.5% in early February 1998 to 16.3% at the end of February 1998. Interest rates were eased three times in August to uphold the economic revival plan. With the selective exchange controls, interest rates were reduced further, together with cuts in SRR. Table 6.6 indicates that the issues were gradually resolved in 1999 as the economy achieved economic improvement in 1999 and 2000.

Table 6.6: Malaysia - Key Macroeconomic and Financial Indicators

	1997	1998	1999	2000
Real GDP growth (annual, %)	5.6	-10.3	6.1	8.3
Gross national savings (% of GNP)	39.4	41.9	41.1	39.5
CPI growth (%)	2.9	5.3	2.8	1.6
Unemployment rate (quarterly, %)	2.5	3.4	3.4	3.1
Federal Government overall balance (% of GNP)	2.0	-1.9	-3.2	-5.8
Current account balance {% of GNP)	-5.9	13.7	17.1	10.2
External debt (% of GNP)	64.0	60.2	n.a	50.5
Net international reserves				
RM billion	59.1	99.4	117.2	113.5
US billion	21.7	26.2	30.8	29.9
M3 growth (%)	18.5	2.7	8.3	5.0
3-month interbank rate (%)	8.7	6.5	3.18	3.25
BLR (commercial banks, %)	10.3	8.0	6.79	6.78
Banking system loans (annual growth, %)	26.5	1.3	n.a	n.a
RWCR of banking system	10.5	11.8	n.a	n.a
Net NPL of banking system (% of total loans) (6-month classification)	4.7	7.5	n.a	n.a

Source: BNM Annual Reports and Special Reports (BNM, 1999c, 2001a)

6.7 Conclusion

In Malaysia, IMF's political influence was not strong due to the force in safeguarding the NEP principles. Even though the international players and radical policymakers in the MoF and BNM had backed Anwar's rescue program, it did not manage to overpower Mahathir's authority. Subsequently, Mahathir ousted his Anwar and implemented the capital control policy. The policy was not formed to override the full financial liberalisation process but rather to curb capital outflows, as there was no restriction placed on FDI and the controls on capital outflows were removed gradually.

The process in the establishment of the capital control policy was a rigorous and challenging process and took about 11 months to be developed via 45 discussion papers (the "Notes") and technical meetings nearly every morning during the period (Wong, 2011). However, there was no evidence of a special Shariah advisor or a *Mufti* being present at such meetings. Based on the review of the Notes, there were no reference made to any Shariah or Islamic principles.

CHAPTER 7: CONCLUSION

> "Islam is a way of life, a practical religion which guides and provides for dealing with every aspect of life. Muslims cannot continue to be satisfied with vague statements that "Islam is a complete way of life" with no attempt to operationalise Islam's eternal ideals in our practical day-to-day life. If we say that Islam is for all times, then we must apply it to the conditions prevailing in our times."
>
> Mahathir (1987a)

Most studies of the Panic of 1997 focus on economic issues such as how the crisis originated, why particular countries like Taiwan and Singapore were largely unaffected, why some countries turned to the IMF for help while others, like Malaysia, generally did not, and how the Crisis affected regional economic cooperation through ASEAN. Even when the existing literature deals with the more political aspects to the Panic of 1997, it discusses the process of economy i.e. corporate, financial, and labour reform, or it addresses the issues of why some countries adopted a neoliberal economic policy regime and how successful they were in implementing neoliberal economic policies. In other words, the existing literature is primarily oriented towards specific economic policies and policy-making process. These literatures pay little attention to the rationale behind the policymakers' decisions, whether it was because of political pragmatism or other alternative reasons.

What was the exact framework of economic policies in Malaysia? What were the cultural and other motivations of the policymakers (in implementing the NEP) in response to the ethical riot and (in implementing the capital controls policy) in response to the Panic of 1997? How did the different motivations of the different actors affect the policies in Malaysia? How did the underlying principles of Shariah, if any, contribute to the eventual decision-making process in response to the Panic of 1997? Were there any alternatives to the policy response logic? If so, did they fail? These are questions posed at the beginning of this thesis. In answering them, the thesis demonstrates that Malaysia's policy response logic resulted from a historical process and that Malaysia's policy responses were not an engineered act that was manufactured on the eve of its Independence in 1957. Rather, the preservation of multi-ethnic unity, a build-up of historical processes had resulted in the responses.

In explaining Malaysia's policy framework, the cultural motivations of the policymakers and the policy response logic, this thesis is sprinkled with terms like "prospects", "processes", "consolidation", "intervention" and "institutions." These terms are linked to the theories of path dependence, the self-reinforcement structure and timing. The thesis argued that the policy responses, the integration of new actors to the conservation of Malay political power, are subjects to a path-dependent process. It also analyses how policies such as the NEP, Islamisation and NERP set off social, political, and economic processes, which in the long run would prove to be transformative.

This thesis does not offer the sole explanation of Malaysia's policy response to the Panic of 1997 but to a certain extent, the analysis adds to the repertoire of works that attempt to make sense of Malaysia's policy responses by giving the historical institutionalist perspective. I have argued that the attractiveness of the historical institutionalist argument lies in its ability to reconcile various works on the policy responses to the Panic of 1997 and, in the process, help make better sense of Malaysia's policy responses logic. A historical institutional assessment can explain alternative reason to the many subjects in Malaysia's political economy including nationalism, religiosity, affirmative actions, and the importance of institutions. The historical institutional line of reasoning can also facilitate to justify the importance of multi-ethnic unity via the NEP, and to some extent Islamisation in Malaysian politics.

During the Mahathir years, Malaysia was known to be a strong advocate in promoting the Islamic approach locally and internationally. Domestically, Islam had been the strength in uniting the Malays in the battle for its independence in 1957. Although Mahathir had very little training in the religious sciences, his readiness to engage seriously with Islam set him apart from his contemporaries. In the Muslim world, his name resonates as a leader willing to question the Western world's hegemonic affirmation to a singular modernity and his willingness to consider alternative models of development.

After Independence, the absolute affinity of ethnicity with religion was such an integral element to the Malay thinking that Islam grew to become a crucial constituent factor in the constitutional interpretation of a Malay (Yasin, 1994). The Independence Constitution defines a Malay as one who "professes the religion of Islam, habitually speaks the Malay language, conforms to Malay custom" (Hashim, Lee and Trindade, 1978). Islam is an essential principle in the ethnic affiliation/composition, specifically in a condition that calls for the unification of the community. An idealised Islam was also proclaimed as an alternative philosophy to the mundane, immediate material interest values proposed by the West (Yasin, 1994). To the Malays, Islam has become "the foundation of communal identity" (Enloe, 1970, p. 27) and "a principal means of defining ethnic loyalty" (Bakar, 1984, p. 139).

I conclude that the concept of globalisation was not to be a concern for the *Ummah* as Islam is pro-globalisation. Despite his anti-West rhetoric gestures, Mahathir is not against globalisation as he believed that the ultimate goal of an Islamic nation is the provision of universal goods for all people. He is merely against what he and many Muslims recognised as the exploitations and transgressions in the current practice of globalisation predominantly in the financial markets. The principle of trade and business transactions from the Islamic perspective of Southeast Asia Muslims should be just and fair, despite the prevailing phenomena of global trade displaying numerous unjust elements, especially the rapid growth of financialisation.

The concept of Shariah and its tradition in Malaysia has consistently been a controversial issue, either among the Muslims or non-Muslims. During the colonial rule, the 'British Residential System' was introduced, and it marked the onset of a secularisation era which detached the state from religion (Yasin, 1994). The modern English legal system was adopted as the law and regulation in all non-religious facets of life. It was described as the only system that was able in bringing about change and economic development. Prior to this, the Shariah law had been practiced as a purely religious law in administering the state affairs. I argue that an all-embracing Islamic community in Malaysia did not exist, although Islam had arrived in Malaya before the British came to rule.

Post-independence, especially during the Mahathir years, the Islamic law or Shariah was expanded to economic and finance and used as a tool for economic development, while maintaining the adapted English legal system. For instance, in the system of Malaysian taxation, the *Zakat* paid on income by a Muslim is considered an allowable deduction against the taxable income, so that the practising Muslim paying the *Zakat* will not be 'taxed' twice. It aims to indicate that Islam is a modest religion capable of adapting to change and modern environment. It is also an undertaking to revive the role of Shariah as a government policy as it used to be before the colonial rule. Mahathir had introduced the Islamisation policy as the "inculcation of Islamic values into the government" in early 1983[94]. He believed that Islam is a tolerant religion and claimed that "…when Malaysia adopted Islamic values and declared itself an Islamic country, there was peace and stability and the country developed and grew as never before…" (Mahathir, 2011, p. 478).

This thesis had described how the NEP and Islamisation policy managed to set off processes that facilitated in raising Malay expectations, increase Malay capacity and establish a series of Malay-based institutions. Even though the NEP to some extent achieved its objective of poverty eradication, Mahathir claimed that it had also created some moral hazard in turning *Bumiputera* entrepreneurs to be rent seekers and too reliant on government aid. In essence, a country must have the knowledge and readiness to respond independently and in its own interest, specifically in the situation of crisis.

On the other hand, critics of the NEP had argued that without the NEP, Malaysia may have achieved better economic growth. This argument is probably valid but would have come at the cost of social divergence and worsened the income disparity. The Panic of 1997 if not dealt with discretion, considering the country's factors, may have turned into an intense socio-political turmoil as it did in Indonesia. Indonesia is a country similar to Malaysia in terms of its demography during the 1990s, but was the only country that did not recover from the Panic of 1997 as the IMF's intervention ignored the non-financial elements of the country that had resulted in social and political unrest.

The thesis examines that banking and corporate reforms carried out under the guidance of the NEAC via the NERP to stabilise the Malaysian financial markets. The

[94] This policy is popularly know by Malaysian as '*dasar penerapan nilai-nilai Islam dalam pentadbiran'*, the rational of introducing this policy was to infuse universally accepted Islamic values into the Malaysian civil service in the process of creating a value laden society, rich with moral and ethical values and integrity (Md Yusof *et al.*, 2014, p. 40)

neighbouring countries undertook similar efforts, but with differing results. The AMC framework under the NERP had made excellent progress in its debt recovery programme. In the five years of its planned operation, Danaharta has resolved all 2,905 loan accounts acquired or managed by them. Their projected recovery rate is 57 percent, which is high by international standards. The motivation behind this policy response was to prevent a banking crisis, which could potentially aggravate the already distressed economic condition due to the Panic of 1997.

I argue that IMF's political influence was not strong to override the force that was protecting the NEP principles. Even though the international players and radical policymakers from the MoF and BNM had backed Anwar's rescue program, it did not manage to overpower Mahathir's authority. With the removal of Anwar, Mahathir implemented the capital control policy. The policy was not formed to reverse the full financial liberalisation process, but rather to curb capital outflows. As a matter of fact, there was no restriction placed on FDI and the controls on capital outflows were removed after the economy recovered. In his memoir, Mahathir claimed that "the currency control we imposed helped to staunched the bleed caused by the financial crisis… if a large number of companies are bankrupted, the devastating results are soon felt by everyone and the nation… the idea that inefficient or struggling companies must be closed down is the extreme rather than reasonable version of capitalist thinking" (Mahathir, 2011, p. 770).

The process in the establishment of the capital control policy by the NEAC was a lengthy and challenging process. Even though there was no evidence of a Shariah advisor or *Mufti* being present at such meetings or any references made to Shariah or Islamic principles, the guiding principle for the NEAC's policy response was based on the best interest of the country or the *Ummah*.

Mahathir being the executive chairperson of the NEAC was a forceful advocate in implementing the NERP with no financial aid from the IMF, as he truly believed that any policy intervention from the IMF would cause the reversal of the NEP. He argued that "calling in the IMF would have been a disaster for the Malaysian *ummah*, as the NEP policies are not in keeping with the IMF's idea of free unfettered competition in which the strongest would take all… We had to rack our brains for a solution which would still leave us independent… with a formula that saved the nation and the *Ummah*…The most important change that the Islamic world has to make is to accept reality and to adjust to it without deserting the fundamentals of Islam" (Mahathir, 2000a). The NEP is understood by the Malaysian people to be a significant proponent of national unity, and "tolerance and moderation is clearly a part of the teachings of Islam. If we ignore these teachings, then we will not only be sinning, but we will be depriving ourselves of the benefits of Islam" (Mahathir, 1998).

The NEAC, established as the task force charged with the recovery measures to the Panic of 1997, comprises a body of independent advisors which included the State representatives[95], trade unions, business leaders and think tank heads, but none were from any religious group. The setting up the NEAC from the Shariah*'s* perspective was to reach a consensus or *Ijma* and the use of *Ijtihad* or independent reasoning in formulating the policy responses that will benefit the *Ummah*. Mahathir (2002b) deliberated that "the Quran and the Sunnah will of course be our ultimate guide supported by the application of `*qiyas'* and `*ijma*`' taking through the process of `*Ijtihad'*. Muslims believe that Islam is the most complete of religions because it governs all aspects of life at all times. In terms of trade and financial matters, there is a lot of guidance provided in the Quran and the *Hadith*."

Mahathir's understanding of Islam and Islamic state is backed by Qaradawi's (1981) depiction that an Islamic State is to ascertain justice and the approach can vary with the conditions of time, distance and place. Therefore, the "gates of *Ijtihad*[96] are always open to Muslims to solve their problem collectively…problems in any nature... including hunger, poverty and ills of the society" (Qaradawi, 1981, p. 125).

During the Mahathir years in the 1980s and 1990s, the Islamisation policy was clearly one of the major developments as analysed in detail in Chapter 3. According to Mahathir, "the renaissance that Islamic civilisation so greatly required, could be achieved through

[95] The State representative included the State Chief Ministers and *Menteri Besar*, including those from the opposition parties. *Menteri Besar* is the head of government of each of nine states in Malaysia.

[96] *Ijtihad* means Interpretation or deduction, explained in detail in Chapter 3.

dynamic, contextualized readings of Islam's founding sources through *Ijtihad*" (Mahathir, 1986, pp. 19–20). Mahathir (1987b) argued that *Ijtihad* would enable present day Muslims to build a framework of ethics to deal with policymaking, economics and community to enable them to integrate modernism. Mahathir believed that "the teachings of the Prophet Muhammad ﷺ were not a straightjacket that should constraint the twentieth century Muslim through literalist readings, but a moral-ethical guide whose dynamic spirit meant it could be applied to the changing exigencies of time and space" (Schottmann, 2018, p. 109). He further debated that a Muslim could determine the appropriate decision in whatever new situation he confronted, manoeuvring the difficulties of contemporary life at the same time upholding the sacredness of God's commandments as he believes that "Understanding Islam does not only mean the capability to explain a *hadith*, or outline the mechanics of certain rituals or recite the verses of the Quran. Understanding Islam also means the capacity to explain and put into practice its dynamic and vibrant concepts in contemporary society" (Mahathir, 1984).

In order to take account to what extent Islam had influenced the decision of the policymakers in their policy responses to the Panic of 1997, we need to take Mahathir as an astute and modern Islamic political actor. An examination of his articulation of Islam provides the needed insights into Mahathir's Islamic discourse and perhaps explains the differing roles of his Islamic view and practice in reshaping the country over the period of his administration. The transformative effects of his policy of 'inculcating government with Islamic values', a policy on the "Islamisation of educational curricula, the banking system, public broadcasting content and government protocols" were arguably "Mahathir's most popular policy decisions, earning begrudging kudos even from his most ardent critics in the Islamic opposition" (Schottmann, 2018, p. 6).

From the assessment of this thesis, I argue that Islam had played a vital cultural and institutional role in Malaysian politics especially during the Mahathir years, but it cannot be explicitly established whether the underlying principles of Shariah were seriously deliberated or any Shariah processes were undertaken in formulating these policy responses. It would not be an unfounded assumption to consider that the policy responses were to a certain degree motivated by Mahathir's persistence and inclination to engage actively with Islam and to champion a more respected position for the religion at the highest level of Malaysian polity, the economy and the international finance system that sets him apart from many of his peers in the Muslim world.

A number of issues that I did not consider in this thesis are worth being pursued for further research:

1) The findings of Chapter 5 provided a summarised analysis on the comparison of the financial system restructuring of four countries in South East Asia that was affected by the Panic of 1997. Areas for future research may include detailed analysis on other Islamic countries to determine whether these countries were guided by any underlying Shariah principles, in the restructuring of their financial system.

2) The Panic of 1997 had only affected countries in South East Asia, of which consist of two Islamic countries i.e. Malaysia and Indonesia. Topics for further investigation may consist of a detailed comparative study of these two countries as they are two policy makers with similar socio-political backgrounds facing a similar situation. However, Indonesia had a much slower recovery from the Panic of 1997 as compared to Malaysia.

3) Further comparative research should also be extended on other Islamic countries outside of South East Asia, so that a more definitive assessment concerning the role of Islam's cultural economics in influencing policy change.

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Appendices

Appendix I: Malaysia's Change in Capital Account Regulations in 1994-99

Date	Type of Transaction	Measure
1/17/94	Bank transactions	A ceiling was placed on the net external liability position of domestic banks (excluding trade-related and direct investment inflows) (removed on January 20, 1995).
1/24/94	Portfolio investment	Residents were prohibited to sell the following Malaysian securities to nonresidents: banker's acceptances; negotiable instruments of deposit; Bank Negara bills; treasury bills; government securities (including Islamic securities) with a remaining maturity of up to one year; and Cagamas bonds and notes (whether or not sold or traded on a discount basis) with a remaining maturity of up to one year (removed on August 12, 1994).
2/7/94	Portfolio investment	• Residents were prohibited to sell to nonresidents all forms of private debt securities (including commercial papers, but excluding securities convertible into ordinary shares) with a remaining maturity of one year or less. • The restriction on the sale of Malaysian securities to nonresidents was extended to both the initial issue of the relevant security and the subsequent secondary market trade.
2/23/94	Banking system transactions	Prohibition of forward transactions (on bid side) and nontrade-related swaps by commercial banks with foreign customers to curtail the speculative activities of offshore agents seeking long positions in ringgit (lifted on August 16, 1994).
8/12/94	Portfolio investment	• Restrictions on the sale of Malaysian securities were lifted. • Residents were permitted to sell to nonresidents any Malaysian securities.
12/1/94	Borrowing and lending in domestic and foreign currency	• Nonresident-controlled companies were allowed to obtain credit facilities, including immovable property loans, up to RM 10 million without specific approval, provided that at least 60 percent of their total credit facilities from banking institutions were obtained from Malaysian-owned banking institutions. Short-term trade facility, guarantee, and forward foreign exchange facility were excluded from the computation of the RM 10 million limit in December 1994, while 60:40 rule continued to apply to total short-term trade facilities. • Nonresidents with valid work permits may obtain domestic borrowing to finance up to 60 percent of the purchase price of residential property for their own accommodation; • Residents may borrow in foreign currency up to a total of the equivalent of RM 5 million from nonresidents and from commercial and merchant banks in Malaysia.
6/27/95	Portfolio investment	Corporate residents with a domestic credit facility were allowed to remit funds up to the equivalent of RM 10 million for overseas investment purposes each calendar year.
2/1/96	Payments for invisible transactions	The threshold for the completion of the statistical forms for each remittance to or receipt of funds from, nonresidents was raised from amounts exceeding RM 50,000 to 100,000 or its equivalent in foreign currency.
8/4/97	Banking system transactions	Controls were imposed on banks to limit outstanding noncommercial-related ringgit offer-side swap transactions (i.e., forward order/spot purchases of ringgit by foreign customers) to US$2 million per foreign customer (hedging requirements of foreigners for trade-related and genuine portfolio and foreign direct investments were excluded).
8/28/97	Stock market transactions	A ban on short-selling of the listed securities on the Kuala Lumpur Stock Exchange was introduced to limit speculative pressures on stock prices and exchange rates.
10/97	Real estate transactions	The quota on sales to foreigners of high-end condominiums was raised from 30 percent to 50 percent and foreigners were allowed to acquire two units of condominiums (compared with one earlier) to reduce some of the impending supply in the high-end of the property market.

Appendix I: Malaysia's Change in Capital Account Regulations in 1994-99 (cont'd)

Date	Type of Transaction	Measure
9/1/98	Offshore ringgit market Transactions	A number of selective exchange control measures were introduced aimed specifically at eliminating the offshore ringgit market and restricting the supply of ringgit to speculators: • A requirement was introduced to repatriate all ringgit held offshore (including ringgit deposits in overseas banks) by October 1, 1998 (BNM approval thereafter); approval requirement was imposed to transfer funds between external accounts (freely allowed previously); and licensed offshore banks were prohibited to trade in ringgit assets (allowed up to permitted limits previously). • A limit was introduced on exports and imports of ringgit by resident and nonresident travelers, effective 10/1/99 (no limits existed before); • Residents were prohibited from granting ringgit credit facilities to nonresident corresponding banks and stockbroking companies (subject to a limit previously); • Residents were prohibited from obtaining ringgit credit facilities from nonresidents (subject to limits previously); • All imports and exports were required to be settled in foreign currency. • All purchases and sales of ringgit financial assets can only be transacted through authorized depository institutions; trading in Malaysian shares on Singapore's Central Limit Order Book (CLOB) over-the-counter market became de facto prohibited as a result of strict enforcement of the existing law requiring Malaysian shares to be registered in KLSE and other authorized trades prior to trade.
9/1/98	Portfolio investment	A number of additional measures were introduced aimed at preventing heavy capital outflows by residents and nonresidents: • Approval requirement for nonresidents to convert the ringgit held in external accounts into foreign currency, except for purchases of ringgit assets, conversion of profits, dividends, interest, and other permitted purposes (no such restrictions previously); there is also no restriction on conversions of ringgit funds in external accounts of nonresidents with work permits, embassies, high commissions, central banks, international organizations, and missions of foreign countries in Malaysia. • A 12-month waiting period for nonresidents to convert ringgit proceeds from the sale of Malaysian securities held in external accounts (excluding: FDI flows, repatriation of interest, dividends, fees, commissions, and rental income from portfolio investment) (no such restrictions previously). • A prior approval requirement beyond a certain limit for all residents to invest abroad in any form (previously applied only to corporate residents with domestic borrowing). • A specific limit on exports of foreign currency by residents and up to the amount brought into Malaysia for nonresidents (previously, no restriction on export of foreign currency on person or in baggage of a traveler; export by other means required approval regardless of the amount).
2/15/99	Portfolio investment	The 12-month holding period rule for repatriation of portfolio capital was replaced with: • A graduated system of exit levy on repatriation of the principal of capital investments (in shares, bonds, and other financial instruments, except property investments) made prior to February 15, 1999, with the levy decreasing in the duration of investment, and thus penalizing earlier repatriations (the levy is 30 percent if repatriated less than seven months after entry, 20 percent if in 7-9 months, and 10 percent if nine to twelve months); no levy on principal if repatriated after 12 months, and no exit levy is imposed on profits arising from dividends and interest earned. • A graduated exit levy on the repatriation of the profits from investments made after February 15, 1999 in shares, bonds, and other financial instruments, except property investments, with the levy decreasing in the duration of investment; no levy on principal and profits arising from dividends and interest earned (the levy is 30 percent if repatriated in less than 12 months after the investment was made and 10 percent if repatriated after 12 months).
3/1/99	Ringgit transactions	The ceiling on the import and export of ringgit for border trade with Thailand was raised.
2/18/99	Portfolio investment	Repatriation of funds relating to investments in immovable property is exempted from the exit levy regulations.
4/5/99	Portfolio investment	Investors in MESDAQ (where growth and technology shares are listed) were exempted from the exit levy introduced on February 15, 1999.

Source: IMF (1999b, pp. 21–22)

Appendix II: Capital and Exchange Control Measures in 1997–99

Measure	Motivation
August 4, 1997: Controls were imposed on banks to limit outstanding noncommercial- related ringgit offer-side swap transactions (i.e., forward order/spot purchases of ringgit by foreign customers) to $2 million per foreign customer (hedging requirements of foreigners for trade related and genuine portfolio and foreign direct investments were excluded).	To delink the offshore ringgit market from its onshore counterpart and reduce the upward pressure on domestic onshore interest rates.
September 1, 1998: A number of selective exchange control measures were introduced, including the following. • A requirement was introduced to repatriate all ringgit held offshore (including ringgit deposits in overseas banks) by 10/1/98 (Bank Negara Malaysia approval thereafter); approval requirement was imposed to transfer funds between external accounts (freely allowed previously); and licensed offshore banks were prohibited to trade in ringgit assets (allowed up to permitted limits before). • A limit was introduced on exports and imports of ringgit by resident and nonresident travelers, effective 10/1/99 (no limits existed before). • Residents were prohibited from granting ringgit credit facilities to nonresident corresponding banks and stockbroking companies (subject to a limit previously). • Residents were prohibited from obtaining ringgit credit facilities from nonresidents (subject to limits previously). • All imports and exports were required to be settled in foreign currency. • Malaysian banks were prohibited from conducting transactions in offer-side swaps with nonresident banks (effectively reducing the previous swap limit to zero), and from engaging in reverse repo transactions collateralized by ringgit instruments with nonresident banks. • All purchases and sales of ringgit financial assets can only be transacted through authorized depository institutions; trading in Malaysian shares on Singapore's Central Limit Order Book over-the-counter market became de facto prohibited as a result of a strict enforcement of the existing law requiring Malaysian shares to be registered in the Kuala Lumpur Stock Exchange and other authorized trades prior to trade.	Aimed specifically at eliminating the offshore ringgit market and restricting the supply of ringgit to speculators that can be used to take positions against the ringgit.
September 1, 1998: A number of additional measures were introduced, including the following. • Approval requirement for nonresidents to convert the ringgit held in external accounts into foreign currency, except for purchases of ringgit assets (no such restrictions previously). • A 12-month waiting period (from September 1, 1998 or the date of	Aimed at preventing heavy capital outflows by residents and nonresidents.

Appendix II: Capital and Exchange Control Measures in 1997–99 (cont'd)

entry of funds, which-ever comes later) for nonresidents to convert ringgit proceeds from the sale of Malaysian securities held in external accounts (excludes foreign direct investment flows, repatriation of interest, dividends, fees, commissions, and rental income from portfolio investment).There were no such restrictions previously. • A prior approval requirement beyond a certain limit for all residents to invest abroad in any form (previously applied only to corporate residents with domestic borrowing). • A specific limit on exports of foreign currency by residents and up to the amount brought into Malaysia for nonresidents (previously, export of foreign currency required approval with no specific limit).	
February 15, 1999: The 12-month holding period rule for repatriation of portfolio capital was replaced with the following. • A graduated system of exit levy on repatriation of the principal of capital investments (in shares, bonds, and other financial instruments, except property investments) made prior to 2/15/99, with the levy decreasing in the duration of investment, and thus penalizing earlier repatriations (the levy is 30 percent if repatriated in less than 7 months after the date of entry (or September 1, 1998, whichever comes later), 20 percent if in 7–9 months, and 10 percent if 9–12 months); no levy on principal if repatriated after 12 months and no levy on profits, interest, dividend, or rental income; • A graduated exit levy on the repatriation of the profits from investments made after 2/15/99 in shares, bonds, and other financial instruments, except property investments, with the levy decreasing in the duration of investment; no levy on principal and no levy on interest, dividend, or rental income (the levy is 30 percent if repatriated in less than 12 months after the investment was made and 10 percent if repatriated after 12 months).	To encourage existing portfolio investors to take a longer-term view of their investments in Malaysia, attract new funds to the country, discourage destabilizing short-term flows, and allow for a smoother outflow of funds.
February 18, 1999 and April 5, 1999: Property investments and investors in MESDAQ (where growth and technology shares are listed) were exempted from the exit levy.	To exclude from the controls certain types of investments that are either difficult to liquidate or resemble foreign direct investments.

Source: Ariyoshi *et al* (2000, p. 98)