Institutions, Economic Recovery, and Macroeconomic Vulnerability in Indonesia and Malaysia

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1. Introduction

In Indonesia and Malaysia, the Asian Financial Crisis was as much a political crisis as an economic one. Policies adopted by the respective governments had fostered over a decade of strong economic growth, but this growth came with structural weaknesses that left each country vulnerable to the vagaries of investor confidence and cross-border capital movements. These weaknesses arose from each country’s political economy: in each country an autocratic government used economic policy and political favoritism to reward its supporters with little regard for their potential downstream costs. The Asian Financial Crisis led each country to take extraordinary adjustment measures, and ignited distributional conflicts that ultimately drove Soeharto from power and severely tested the ruling coalition in Malaysia. Subsequently, the years since the crisis have seen political contests in each country over the implementation of reforms designed to foster economic recovery.

This chapter shows how politics has defined the course of economic recovery in Indonesia and Malaysia. Malaysia’s economic recovery began earlier and remained more robust than other countries in the region as a result of the country’s adoption of selective capital controls and an exchange rate peg together with expansionary macroeconomic policy. But Malaysia’s successful stabilization package meant that the government could escape the tough economic reforms that would promote more healthy long-term growth. Most of the same structural weaknesses that made the country vulnerable to the Asian Financial Crisis persist in Malaysia today, even after the retirement of former Prime Minister Mahathir Mohamad. These include extensive political intervention in the economy, as well as corruption and inefficiency in
government owned or politically favored firms. By contrast, the fall of Soeharto and Indonesia’s subsequent democratization, along with IMF mandated stabilization measures and institutional reforms, have not have the much hoped for effect of promoting rapid economic recovery. In particular, Indonesia’s decentralization program has increased opportunities for local corruption, and the implementation of economic reforms has been hamstrung by political instability and corruption at the national level. Only under President Susilo Bambang Yudhoyono, elected in October 2004, have reform measures began to show fruit.

The experiences of Indonesia and Malaysia suggest several insights for the political economy of economic reform. Far-ranging political transitions, as took place in Indonesia, can lead to delays in economic recovery due to the extensive transactions costs associated with institutional re-equilibration—the process whereby economic and political actors adjust to new institutional rules. Democratic transitions and fiscal decentralization, and competition over the ability to define new institutional rules, can yield new opportunities for rent-seeking. The product of these reforms in Indonesia has been a complex regulatory regime coupled with weak legal enforcement. While normatively desirable, democratization and fiscal decentralization have not overcome the fundamental problem of weak institutions that hinder economic growth. Political continuity, as in Malaysia, minimizes the transactions costs associated with institutional re-equilibration. The political tradeoff is that economic recovery masks the need for economic reform, and obscures the same macroeconomic vulnerabilities that earlier led to a severe economic crisis.

The focus on institutions here does not deny the importance of other influences on the course of economic recovery in the two countries. Indonesia’s crisis was far worse than Malaysia’s crisis, in part due to the almost total breakdown of Indonesia’s economic and political
institutions in 1998. This means that Indonesia had further to go to achieve economic recovery than Malaysia did. Political changes in Indonesia also extended far beyond legal and institutional reform: in the provinces of East Timor, Aceh, and West Papua, secessionist movements have threatened the very integrity of the Indonesian state. Sectarian violence in Maluku and Kalimantan brought simmering social conflicts to light, and the Indonesian military has sought contain the new threat of Jemaah Islamiyah while reevaluating its own role in Indonesian politics. Malaysia has had none of these problems. Corruption, too, has always been more extensive in Indonesia than in Malaysia. Yet there is still much to learn from these two countries. Focusing on the (often informal) institutional bases of each country’s economy helps us to understand the mechanisms through which growth occurs and macroeconomic vulnerabilities develop. On this count, the comparison between institutional change and continuity in Indonesia and Malaysia reveals important themes in East Asia’s recovery.

2. Economic Crisis and Recovery

Malaysia’s economic contraction was shallower, and its subsequent growth more robust, than Indonesia’s. A common misperception among many regional specialists is that Malaysia’s crisis was less severe than Indonesia’s because Indonesia was *ex ante* more vulnerable. Indonesia did face a more severe problem of imprudent lending than Malaysia, manifest in a burden of non-performing loans exceeding by some estimates 40% of all loans in Indonesia compared to around 20% in Malaysia.¹ But Malaysian development financing was concentrated in the stock market rather than in bank lending: Malaysia’s stock market capitalization exceeded 227% of GDP in 1995, compared to just 19% in Indonesia (cited in Jomo and Hamilton-Hart

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¹ J.P. Morgan estimated that at the height of the crisis, between 30 and 35 percent of all loans in Indonesia were non-performing. In Malaysia, the figure was 15 to 25 percent. Similar figures for Standard and Poor’s are 40 percent for Indonesia and 20 percent for Malaysia (cited in Berg 1999: 8).
2001: 81). Between its peak on June 8, 1997 and its trough on September 21, 1998, the Jakarta Stock Exchange Composite Index shrank by 65.3%, from 741.8 to 256.8—a severe turnaround by any reckoning. But the Kuala Lumpur Stock Exchange (KLSE) Composite Index, between February 21, 1997 and September 1, 1998, shrank by 79.3% from 1271.6 to just 262.7. For Malaysia’s political economy, dominated by the stock market for the distribution of patronage in addition to the financing of big-ticket development projects, this was a disastrous turnaround.

In fact, the ultimate severity of the economic shock in each country was endogenous to the policies that their regimes adopted in combating the crisis. A comparison of growth rates during the crisis illustrates economic contraction and subsequent recovery, demonstrating the economic consequences of political events in each country (Figure 1).

![Figure 1: Quarterly Real Growth Rates, 1996-2001 (Annualized, Seasonally Adjusted)](source: IMF, *International Financial Statistics*)

The data show that economic contraction actually began earlier in Malaysia than in Indonesia, with negative growth rates first recorded in the first quarter of 1998. As currency and stock speculators attacked Malaysia, anti-Western outbursts by Mahathir and increasing tensions between Mahathir and Deputy Prime Minister and Finance Minister Anwar Ibrahim contributed
further to the country’s economic downturn. But in September 1998, Malaysia embarked on its controversial adjustment strategy of macroeconomic expansion made feasible by capital controls with a fixed ringgit exchange rate—and Mahathir sacked his deputy. Despite this political shake-up, Malaysia’s economic quickly stabilized, and had turned around by mid-1999. In Indonesia, by contrast, while growth slowed abruptly in late 1997, growth did not trend negative until the third quarter of 1998, following Soeharto’s resignation on May 21, 1998. But in the wake of Soeharto’s resignation, the Indonesia economy contracted severely, enough that Indonesia registered a stunning fourteen percent economic contraction in 1998. After bottoming out in the first quarter of 1999, the Indonesian economy rebounded to register positive seasonal growth of just under two percent in the fourth quarter of that year.

Malaysia’s comparatively rapid economic recovery despite its radical departure from IMF orthodoxy of financial openness and macroeconomic discipline sparked some debate about the causal role of Malaysia’s adjustment policies in spurring economic recovery. At the very least, Malaysia’s policies do not seem to have done much harm. Even Paul Krugman, who suggested in August 1998 a policy basket similar to Malaysia’s, has been circumspect in attributing economic recovery to Malaysia’s policies rather than a secular improvement in investment climate (Krugman 1999). There are reasons enough to believe that the correlation between capital controls and the onset of economic recovery is misleading. Economic crises never last forever, and after three quarters of negative GDP growth, Malaysia may have simply bottomed out. Evidence in favor of this conclusion comes from the fact that South Korea and Thailand began to recover about the time that Malaysia began to recover. Alternatively, Malaysia might have recovered still faster had it not imposed capital controls. To assess the counterfactual that Malaysia would have recovered even without capital controls and a ringgit
peg, Kaplan and Rodrik (2001) compared a number of economic indicators in Malaysia with other indicators in South Korea, Indonesia, and Thailand, taking into account that the other countries adopted IMF policies long before September 1998, while Malaysia’s economy was still deteriorating at that time. They find strong support that capital controls in Malaysia were associated with a smaller drop in GDP growth, industrial output, and real wages than the IMF programs in other crisis countries.

Since 1999, the year by which the crisis in each country had finally abated, both countries’ economies have grown steadily, although at lower rates than they enjoyed before the crisis (Figure 2).

![Figure 2: Real Per Capita GDP, 1990-2005](image)

In Indonesia, per capita real GDP grew by an average of 5.66% between 1991 and 1996, but this has slowed to 3.05% between 1999 and 2005. In Malaysia, the same figures are 6.72% between 1991 and 1996 and 3.49% between 1999 and 2005. Malaysian GDP did contract in 2001 due to a slump in global demand for Malaysian electronic exports coinciding with a global economic slowdown (see Martinez 2002). But the trends over time are clear: the economic crisis
represents a clear break in each country between a period of rapid economic growth amidst relatively stable politics and a period of more modest economic growth.

3. **Indonesia: Institutional Change and Macroeconomic Vulnerability**

Indonesia’s severe economic contraction drove Soeharto from power, spelling the end of the New Order regime over which he had ruled for thirty-two years. Soeharto’s hand-picked successor, B.J. Habibie, was singularly unable to contain Indonesia’s *reformasi* movement, and in 1999 lost Indonesia’s first democratic election since the 1950s to the liberal Muslim politician Abdurrahman Wahid (Gus Dur) of the National Awakening Party. Gus Dur, however, served erratically, alienating pro-democracy activists and allied political parties alike while mismanaging Indonesia’s economic recovery and using his position to amass financial resources through the state’s logistical monopoly Bulog (Liddle 2001; Malley 2002). He himself succumbed to a corruption scandal in 2001, succeeded by his Vice President, Megawati Sukarnoputri of the Indonesian Democratic Party of Struggle (PDI-P). In contesting the first direct presidential election in 2004, Megawati lost to her former Coordinating Minister for Politics and Security, General Susilo Bambang Yudhoyono, usually known by his initials SBY. This total of five Presidents within the space of just eight years is an important indicator of the political changes ushered in by Indonesia’s economic crisis.

Presidential turnover notwithstanding, a persistent concern for Indonesia is the penetration of the Indonesian government by wealthy *pribumi* (“indigenous,” i.e. non-Chinese Indonesian) business figures. SBY’s Vice President is Jusuf Kalla, who had a long career as head of the influential conglomerate NV Hadji Kalla while rising in the ranks of the dominant party Golkar during the New Order. His brother, Achmad Kalla, currently heads PT Bukaka Teknik Utama, a multinational firm with diversified construction investments of which Jusuf was
a commissioner until 2001. Under SBY, Bukaka and Hadji Kalla have won a number of important concessions from central and regional governments. SBY’s wife Kristiani Herawati is the daughter of the late General Sarwo Edhie Wibowo, who was instrumental in the massacre of students and leftists during Soeharto’s rise to power in 1965. Many believe that she has business connections owing to her strong family ties to the military, and efforts to extricate the Indonesian military from the corporate world have been halting.² Besides Jusuf Kalla, other members of SBY’s United Indonesia Cabinet have clear links with the Indonesian business community, including the Coordinating Minister for People’s Welfare and former Coordinating Minister of the Economy Aburizal Bakrie, whose family controls the influential Bakrie Group, and Minister for National Planning Paskah Suzetta, whose business interests have included property and investment. The Bakrie Group openly collaborates with the National Planning Board (Bappenas) to develop its land holdings, and Aburizal’s wealth has grown substantially since he joined SBY’s government.³ Foreign economic observers agree that business interests such as these have hindered the course of Indonesian trade policy reform.⁴ Government trading monopolies and government-owned enterprises still exist in many sectors; these firms are reported to be rife with corruption, and privatization drives yield speculation of corruption and favoritism.⁵

Indonesia’s central bank is now formally independent from the executive and legislature, but reports of interference by Kalla and others in the Bank’s monetary policy decisions are common.⁶

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⁴ Several interviews with officials at international development agencies in Jakarta, February-March 2006.
⁶ Interview with an economist at a foreign economic institution, February 2006.
The news is not all bad, as other economic ministers in SBY’s Cabinet, notably the current Coordinating Minister for the Economy Boediono, Minister of Finance Sri Mulyani Indrawati, and Minister of Trade Mari Elke Pangestu, have reputations as technocrats rather than business figures. The technocrats have directed several contentious but much-needed policy reforms, including fuel subsidy cuts of October 2005 that were unpopular among many lower class Indonesians. Yet the bifurcation of SBY’s Cabinet between technocrats and well-connected entrepreneurs recalls the policy divide under Soeharto between technocrats, and so-called “financial generals” and nationalists (see Crouch 1978; Liddle 1991: 29-32; Mackie and MacIntyre 1994: 35-37). Based on the presence of so many members of the New Order establishment in post-New Order governments, some have suggested that Indonesia has developed a ruling oligarchy that has weathered a difficult institutional transition without actually losing its power (see e.g. Robison and Hadiz 2004).

This is probably an exaggeration. Even though many members of the New Order elite have survived the transition to democracy, the rules of the game have changed in important ways. The change from dictatorship to democracy on a national scale is only the beginning. In 2001, Indonesia embarked on a radical policy of decentralization that dismantled many of the institutions of centralized political rule under the New Order. Constitutional amendments in 2004 reinforced this move towards regional autonomy (otonomi daerah). Not only are national elections democratic, so are provincial and local elections. With decentralization has come a new phenomenon of regional splitting (pemekaran daerah, or “the blossoming of areas”), referring to the subdivision of existing subnational political units into new ones. Since 1998, seven new provinces have been created: North Maluku, formerly part of Maluku, in 1999; Bangka-Belitung, formerly part of South Sumatra, in 2000; Banten, formerly part of West Java,
also in 2000; Gorontalo, formerly part of North Sulawesi, also in 2000; West Irian Jaya (Irian Jaya Barat), formerly part of Papua, in 2003; Riau Islands (Kepulauan Riau), formerly part of Riau, in 2004, and West Sulawesi (Sulawesi Barat), formerly part of South Sulawesi, also in 2004. With the loss of East Timor, this has raised the number of Indonesian provinces from 27 in 1998 to 33 today. Other new provinces have been proposed as well, including a province of Central Irian Jaya, a province of East Sulawesi, and several subdivisions of Aceh (Nanggroe Aceh Darussalam). At the sub-provincial level, over a hundred new regencies (kabupaten) and cities (kota) have been created.

Political decentralization—in particular, fiscal decentralization—has a clear economic logic. It removes the central government’s monopoly over the creation of many important facets of economic policy, inducing subnational political units to compete with one another to attract investment (see e.g. Tiebout 1956; Weingast 1995). For example, provinces that eliminate inefficient labor regulations will attract more investment; and this will encourage other provinces to emulate them. Combined with local level democracy, this gives citizens a powerful tool to enhance government responsiveness and spur local economic development. Even if provincial administrations do not respond to logic of inter-jurisdictional competition, instead using their positions to generate personal profit or to protect vested interests, with democratic elections their constituents will punish them for corruption and poor governance by voting them out of office. In Indonesia, several studies have found that local level corruption has decreased since decentralization in 2001 (Henderson and Kuncoro 2004, 2006). This is consistent with cross-national evidence, which finds a negative relationship between decentralization and corruption at the national level (see e.g. Fisman and Gatti 2002).
But many Indonesian political observers have found a perverse logic to decentralization and regional splitting. Instead of fostering inter-jurisdictional competition, decentralization and regional splitting have increased the opportunities for local corruption by expanding the number of independent veto points and government agencies across the country.\footnote{Interview with an official at an international development agency in Jakarta, March 2006.} Without the heavy hand of Soeharto in the background, these agencies are now even more willing to extort bribes and levies. Local elites interested in securing regular funding from the central government can create what amount to personal fiefdoms in new sub-provincial jurisdictions. The logic is similar to that of Shleifer and Vishny (1993), who suggest two different institutional equilibria that support corruption. In one, a strong central government has an incentive to maximize its total take in bribes from an economy, and hence punishes its lower level representatives in the regions if they levy bribes to an extent that they discourage growth and investment. Such an institutional structure leads to a high total number of bribes taken, but a relatively small average bribe, and New Order Indonesia matched this model well (see MacIntyre 2000, 2003). An alternative institutional structure has no central apparatus that can coordinate bribery and corruption among bureaucrats or government agencies throughout a country. The lack of coordination among bribe takers implies that the total amount of bribery may be lower than under a centralized regime, but that each individual bribe will be larger than under the centralized regime. The implication for investment, growth, and development is that centralized corruption, while inefficient, is more efficient than decentralized corruption. There are now higher transactions costs to negotiating contracts and getting investment approval—without central coordination, it is less clear who to bribe, how much to bribe, or whether each bribe paid will be the last. For this and related

This perspective suggests a tantalizing hypothesis about the overall effect of decentralization on long-run economic growth. Could Indonesia’s decentralization actually be harmful to long-run growth by decoupling the many opportunities for bribery and extortion in the Indonesian economy from a strong, centralized leader? Consider first the trends in perceived corruption over time. Indonesia has always been one of the world’s most corrupt countries, consistently registering at the bottom of cross-national indices of corruption. Transparency International always places Indonesia in the bottom quartile of all countries, similar to many countries in Central Asia and many emerging markets in sub-Saharan Africa. On a scale of 1-10, with one the most corrupt and 10 the least, Indonesia averages around 2 (Table 1).

\begin{table}[h]
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1.9 & 2.7 & 2.7 & 2.0 & 1.7 & 1.7 & 1.9 & 1.9 & 1.9 & 2.0 & 2.2 \\
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\caption{Indonesia, Corruption Scores, 1995-2005}
\label{tab:corruption}
\end{table}
An interesting trend is apparent in the data. While Indonesia has transitioned to democracy and adopted a wide-ranging program of decentralization, and while Indonesia is slowly improving from the valley of 1.7 in 1999 and 2000, Transparency International rates it as more corrupt in 2005 than in 1996; that is, Indonesia has yet to recover to even its pre-crisis level of corruption. We can compare the time trend in corruption to investment approvals per year (Figure 3).

![Figure 3: Indonesia, Domestic and Foreign Direct Investment Approvals, in Billions of Rupiah, 1993-2005](image)

Figure 3: *Indonesia, Domestic and Foreign Direct Investment Approvals, in Billions of Rupiah, 1993-2005*

*Source: Bank Indonesia*

Both foreign direct investment and domestic investment in Indonesia remain much lower in the wake of the crisis they were before the crisis. In a highly open, export-oriented economy such as Indonesia, this fall in investment is likely the single greatest cause of the country’s slower economic growth in the wake of the crisis. For example, the government revealed in March 2006 that of ninety crucial infrastructure projects for which the government has sought tenders, less than twenty percent had attracted any attention from investors. Shortly thereafter, World Bank President and former US Ambassador to Indonesia Paul Wolfowitz stated that corruption was the single greatest hindrance to investment in Indonesia.9

There are many reasons to be wary of generalizing from this simple correlation between stubbornly persistent corruption and the failure of investment in Indonesia to rebound in the decade after the Asian Financial Crisis. Cross-national data on corruption is notoriously unreliable, and the movements in the Transparency International series are quite small when compared to the overall range of possible scores. Moreover, there are certainly other factors that have influenced investment decisions in Indonesia, in particular the rise of China, India, and Vietnam as low-cost competitors for foreign direct investment. Additionally, as noted in the introduction, the breakdown of the New Order gave rise to open secessionist conflicts in three different provinces, and terrorists have attacked foreign interests in Java and Bali; such political strife has certainly given domestic and foreign investors pause. Since democratization, moreover, labor has been free to organize for better wages and working conditions, which may have driven away some investors who formerly enjoyed Indonesia’s controlled labor force.

But other characteristics of post-Soeharto Indonesian politics suggest that decentralization has not been as successful as many hoped in attracting investment. Since his election, SBY’s administration and Indonesian business groups have repeatedly exhorted provincial and sub-provincial governments to adopt streamlined investment regulations.

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April 2006, the central government announced two new regulations to facilitate regional growth, permitting regions to designate special economic zones without central government approval and forbidding regions from imposing any new taxes, and yet while regions can now issue permits to foreign direct investors, they must still seek approval from the central government.13 The fact that SBY and his Cabinet members continue to prevail upon regional administrations to embark on such reforms, and that the central government continues to shoulder the responsibility for creating a good investment climate for needed infrastructural investment through pro-investment regulations, indicates that decentralization itself is not yet having its desired impact.14

There are, then, two seemingly opposing claims. At the provincial and sub-provincial level, decentralization seems to be associated with lower corruption, but at the national level the country is as corrupt as ever, and the investment climate remains unattractive. One promising way to square these claims comes from Henderson and Kuncoro’s (2006) finding that only when Islamic parties win local elections does local corruption decline. Islamic parties such as Partai Keadilan Sejahtera (The Prosperous Justice Party) have a reputation as being less corrupt than other Indonesian political parties, and the mechanism through which they attract voters may be less their Islamist message than their commitment to government that is “clean and caring” (bersih dan peduli). If this is the case, then it suggests that at least in Indonesia, what makes decentralization effective is not inter-jurisdictional competition itself, but its combination with

local democracy and rotation of power. This still, however, leaves unexplained why
decentralization and rotation of power have so far not led provinces to improve their investment
climates. Perhaps the safest conclusion about Indonesia’s transition to democracy and the move
to decentralization and regional autonomy is that their beneficial effects, at least until now, have
been small and delayed. Provinces and sub-provincial administrations have been slow to adopt
reforms that attract investment and combat Indonesia’s (relatively) high cost economy.
Moreover, the level of corruption in Indonesia is still worrisome, and there is wide agreement
among Indonesians that corruption is greatest threat to Indonesia’s macroeconomy.

At the national level, decentralization cannot solve the problem of corruption, and
Indonesian political leaders recognize that doing so requires firm action by the central
government. There have been some encouraging steps. Successive governments have
empowered supervisory agencies such as the Capital Market Supervisory Agency, the Finance
and Development Supervisory Agency, and the Office of Public Accounts to combat financial
improprieties, and reform of the country’s clumsy and corrupt tax collection agencies remains a
high government priority. Yet many question these institutions’ ability to execute their tasks
because of a lack of legal protection and unclear regulations. 15 On corruption, Gus Dur and
Megawati each created coordinating bodies to combat corruption, collusion, and nepotism, the
most influential among them being the Corruption Eradication Commission, formed in 2002.
SBY’s government has staked its reputation on eradicating corruption, and has created two new
bodies, the Corruptors’ Search Team in 2004 and the Coordinating Team for the Eradication of
Corrupt Practices in 2005. But results have been slow, with overlapping responsibilities, limited

15 “Pembentukan komisi independen pajak dipercepat,” Bisnis Indonesia, February 8, 2006; “IMF desak RI
reformasi pajak ,” Bisnis Indonesia, February 20, 2006; “Peran KAP ungkap korupsi masih minim”,” Bisnis
Indonesia, June 1, 2006.
protection for witnesses, and a lack of coordination among the several extant anti-corruption agencies hindering successful prosecution of suspects (see Yuntho 2005b).

While the Indonesian press issues new reports of corruption investigations almost daily, there are frequent criticisms that the most corrupt and politically connected figures escape prosecution. The on-going Bank Indonesia Liquidity Support scandal—referring to the massive amount of liquidity support doled out to cronies controlled banks at the height of the crisis—has yet to reach much of a conclusion. Some of the biggest corruptors simply vanished overseas, and others arranged to have their repossessed assets overvalued by government auditors in order to minimize their losses (Mintorahardjo 2001: 25-53; Yuntho 2005a). In other areas, despite several high profile cases in which corrupt politicians and businessmen have been convicted, the deterrent effect of national anti-corruption efforts seems minimal. For instance, Soeharto’s third son Tommy (Hutomo Mandala Putra) was sentenced in 2001 to eighteen months in prison for corruption, but for months he avoided detention. His corruption conviction was overturned, but not until after he masterminded the revenge killing of the Supreme Court Justice M. Syafiiuddin Kartasasmita (who had presided over his first trial), a crime for which he was sentenced to fifteen years in prison. Tommy has served his sentence with relative ease, using funds from his Humpuss Group to build a badminton court on prison grounds, receiving extended visits from models, periodically using complaints of stomach pain to seek respites from

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incarceration, and repeatedly earning sentence reductions.\textsuperscript{19} Were it not for Tommy’s decision to murder a judge, he would be free today, like his famously corrupt sister Tutut and his father, who has been repeatedly deemed too ill to stand trial.

Under SBY, whose administration has undoubtedly done more to combat corruption than its predecessors, a troubling new trend is the bribery of legal officials associated with corruption investigations. Credible reports appear periodically that members of the Corruption Eradication Commission have accepted bribes and intimidated witnesses.\textsuperscript{20} Soeharto’s half-brother, Probosutedjo, confessed to bribing Chief Justice Bagir Manan, who presided over his corruption trial in 2003. Since then, prosecutors have brought charges against several Supreme Court employees, but Bagir remains untouched in the wake of jurisdictional spats between the Supreme Court and the Corruption Eradication Commission.\textsuperscript{21} A similar case involves Achmad Djunaidi, who as president of the state-owned workers’ insurance cooperative PT Jamsostek oversaw a number of shady investment deals that ultimately cost the Indonesian government more than Rp 200 billion (around US$21.6 million). Upon being sentenced to eight years in prison in April 2006, Achmad revealed that he had paid Rp 600 million (around US$65,000) to government lawyers as a bribe to avoid jail time.\textsuperscript{22} Two attorneys in the Attorney-General’s office have been dismissed, and may face questioning from the Corruption Eradication Commission, but the


blatant nature of the corruption involved raises concerns about the SBY administration’s ability to prosecute corruption cases successfully.

In sum, we can draw several conclusions about the post-Soeharto Indonesian political economy. Government-business relations remain extremely close, and many of the big *pribumi* entrepreneurs from the New Order have risen in the government. But the institutional context of government-business relations has changed with decentralization and democratization. The national government must now negotiate with provincial governments, few of which have made great strides in improving the local investment climate. Corruption is now decentralized, and perhaps more growth retarding than corruption under the New Order. There is tentative evidence that local corruption has decreased with decentralization and local political competition, but at the national level it still remains the greatest threat to Indonesia’s macroeconomic stability, even given the SBY administration’s attempts to bring corrupt politicians and business figures to justice. Perhaps ironically, these vulnerabilities are what will probably shield Indonesia from the same sort of meltdown that it experienced in 1997-1998, as foreign and domestic investors are far more hesitant to invest in Indonesia than in the mid-1990s. Indonesia’s vulnerability is now of a different sort: that of a low-investment, low-growth equilibrium that undoes public support for democracy and regional autonomy.23

4. **Malaysia: Institutional Continuity and Macroeconomic Vulnerability**

Economic recovery in concert with political repression allowed Mahathir’s regime to withstand a political challenge from Anwar and a newly galvanized political opposition. The engine of this political opposition was Malaysia’s *reformasi* movement, which championed the causes of reform and social justice and catalyzed the formation of the Barisan Alternatif.

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23 See recent data from Mujani (2006) for evidence that Indonesia’s slow growth negatively influences Indonesians’ support for democracy.
(Alternative Front, BA), an electoral coalition among the Pan-Malaysian Islamic Party (PAS), the largely Chinese Democratic Action Party (DAP), and the pan-ethnic National Justice Party (Keadilan) founded by Anwar’s wife Wan Azizah Wan Ismail. In the 1999 general elections, PAS captured an additional state legislature for a total of two out of thirteen, and expanded its small share of seats in Malaysia’s lower house. Yet the ruling Barisan Nasional (National Front, BN) coalition, led by UMNO and Mahathir, easily retained the two-thirds majority in the lower house that it had enjoyed since the suspension of democracy in 1969. In the wake of the BN’s victory, Mahathir moved against many of his political opponents (Abbott 2004: 80-81; Committee to Protect Journalists 2000; Netto 1999), reinforcing his firm grip over Malaysian politics and society. Mahathir continued to rule until 2003, when he handed the reigns of power to Deputy Prime Minister Abdullah Ahmad Badawi. Abdullah led the BN to an overwhelming victory in the 2004 general elections, reaffirming UMNO and the BN’s position at the apex of Malaysia’s regime.

This political continuity means that at the institutional level, Malaysia’s political economy has changed little between 1996 and 2006. On one hand, this has provided a boon to investment (Figure 4), as foreign and domestic companies continue to be attracted to the country’s relative political stability and quiescent labor force.
The data show that like in Indonesia, foreign investment declined in 1997, but unlike Indonesia, has since recovered to beyond pre-crisis levels. The spikes in domestic investment reflect expansionary fiscal policies launched by the government in 1998 and again in 2001. But in contrast to this favorable picture of investment recovery which has driven Malaysia’s post-crisis economic growth, political continuity in Malaysia means that there has been little meaningful reform in the policy areas that contributed to the country’s macroeconomic vulnerability in the late 1990s.

Table 2: Malaysia, Corruption Scores, 1995-2005
Source: Transparency International

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As measured by Transparency International, for example, Malaysia is almost precisely as corrupt in 2005 as it was in 1995—although, like Indonesia, corruption worsened in the wake of the country’s economic crisis before making a modest recovery.

The increase in corruption from 1999 through 2002 stems largely from measures that the regime took to foster economic recovery. While capital controls and expansionary
macroeconomic policy allowed the regime to jumpstart economic growth, they also allowed the regime to rescue politically connected firms without the fear of punishment from foreign traders. To resolve outstanding issues of corporate debt and weak financial institutions, the government created two quasi-governmental bodies tasked with acquiring non-performing loans and injecting capital into weak banks (Danaharta and Danamodal). A Corporate Debt Restructuring Committee facilitated these tasks (see Mahani 2002). But there was clear evidence of favoritism in these bodies’ operations. The government bought out shares in the deeply indebted Malaysian Airlines Systems from Tajudin Ramli, a corporate ally of former Finance Minister Daim Zainuddin, at an inflated price that allowed Tajudin to pay off his own extensive debts. The government also bought a controlling stake in Time dotCom Bhd, using public funds to complement private investment after a failed initial public offering. Time dotCom is a subsidiary of Time Engineering Bhd, in turn controlled by the government-linked conglomerate Renong Bhd, which had long been one of UMNO’s corporate arms. Just six months later, after a falling out between Mahathir and Daim, the government bought a controlling stake in Renong, which itself remained mired deeply in debt. Such examples abound of Mahathir’s regime using public funds to protect political interests during this period of recovery. Johnson and Mitton (2003) find that the stock prices of publicly listed companies with links to Mahathir recovered faster than stock prices of unaffiliated firms, and that both recovered faster than stock prices of firms associated with Anwar.

The onset of Abdullah’s tenure in office was a moment of optimism for many observers of Malaysian politics (Welsh 2005). Under his leadership, the final remnants of Malaysia’s radical adjustment measures—bans on short-selling of stocks and the ringgit’s hard peg to the

US dollar—have been lifted. He has a reputation of being personally incorruptible, and he immediately embarked on an ambitious program to streamline government-linked companies (GLCs) and root out public sector inefficiency. On these counts, he can claim some modest success, having introduced procurement standards and efficiency guidelines and replaced ineffective executives in some GLCs. Yet close examination of Malaysian politics and economic management shows that the tight relationship between business and politics persists. Several promised reforms have yet to come to pass, such as the establishment of an open tender system for government procurement and a fair competition law. While the late 1980s saw official privatization of many companies, the government retains a large stake in conglomerates in key sectors. Some government-controlled firms such as Telekom Malaysia Berhad (telecommunications) and Petronas (petroleum exploration and refining) are notably professional and have expanded beyond Malaysia’s borders, but others such as Tenaga Nasional Berhad (power generation) have retained their influence through size rather than efficiency. Furthermore, political favoritism granted to clearly inefficient companies such as the national automobile company Proton persists, reflecting both the continued influence of Mahathir on daily politics (he is now Proton’s “special advisor”) and Abdullah’s inability to combat entrenched interests.

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From the standpoint of UMNO’s leadership, control over budgetary purse strings has reached paramount importance. As part of his strategy to sideline Anwar, Mahathir took temporary control of the Ministry of Finance, and later gave the Finance portfolio to his longtime ally Daim Zainuddin, a Malay businessman who built his billion dollar fortune through a close association with UMNO leaders and who had previously occupied this position from 1984 to 1991. Daim served until 2001, when Mahathir assumed the position himself. Daim ostensibly resigned on his own accord, but political observers have noted that Daim’s business interests had come into conflict with the business interests of Mahathir’s son Mokhzani Mahathir.31 Since rising to the position of Prime Minister, Abdullah has continued Mahathir’s practice of holding the Finance portfolio. Also of note is the continued existence of the National Economic Action Council (NEAC), a super-constitutional organ that Mahathir created in late 1997 to find a solution to the country’s economic crisis. Although the crisis has long since abated, the NEAC continues to exist as a body with wide discretionary authority over economic management, superseding that of economic ministries such as Trade and Industry, Public Works, Finance, and others. At the head of its Executive Committee sits the Prime Minister, the Deputy Prime Minister, and an executive chair who also serves as Minister in the Prime Minister’s Department. If anything, this is evidence of more political centralization of economic policy formation than under Mahathir’s rule before the crisis.

Besides maintaining the high level of centralization in economic policy making, Abdullah has retained a number of Mahathir’s cronies who had under Mahathir served as members of his economic team. Rafidah Aziz, a long time Mahathir loyalist with several corruption scandals already under her belt, remains Abdullah’s Minister of International Trade and Industry. S. Samy Vellu, President of the BN’s Indian component party the Malaysian Indian Congress and a

figure long noted for his egregious use of patronage to secure office,\textsuperscript{32} has retained his influential position as the Minister of Public Works. Abdullah has retained other figures as well, leading many observers to question Abdullah’s independence from the UMNO party machine.\textsuperscript{33} Such continuity of Malaysian politics reveals that despite Abdullah’s reputation as a clean politician without crony linkages to the business community, opposition from entrenched interests in UMNO and the BN makes it unlikely that he will introduce wide ranging and effective reforms. Moreover, Abdullah’s son-in-law Khairy Jamaluddin, viewed as having extraordinary personal influence over Abdullah, has seen his personal wealth grow extensively since 2004 at what many believe to be shady investment deals dependent on political favoritism.\textsuperscript{34} Additionally, Abdullah’s deputy Najib Abdul Razak has none of Abdullah’s reputation for moderation and clean government. Instead, he is known as a staunch defender of Malay special rights and of UMNO, and is often identified with the politics of his father, Abdul Razak Hussein, who engineered the move toward overt UMNO dominance of Malaysian politics during the period of suspended democracy from 1969-1971.

If the personal inclinations of power holders (aside from Abdullah) are less than encouraging, developments in the government’s intervention in the economy reveal that the main institutional weaknesses of the Malaysian government have persisted as well. The regime has not retreated from its long advocacy of Malay political dominance and favoritism for Malays in business and society. (In Malaysia, “positive discrimination” officially benefits all \textit{bumiputras}, or non-Chinese and non-Indians, but Malays are the main beneficiaries of this favoritism.) A

\textsuperscript{34}Anonymous interview with a Malaysian economist, July 2006.
revealing document is the Ninth Malaysia Plan (Government of Malaysia 2006), Malaysia’s first five-year development plan issued under Abdullah, which the government released to great domestic fanfare in February 2006. The Plan, like its predecessors, places heavy emphasis on the government’s role in coordinating the redistribution of wealth and equity in favor of bumiputras, largely at the expense of the country’s large Chinese Malaysian minority.35

There are many ways in which the government intervenes in the economy to sponsor interethnic redistribution, many of which have created macroeconomic vulnerabilities in the past. For instance, in a worrying continuation of policies long implemented under Mahathir and his predecessors, the government continues to manage a number of bumiputra-only unit trusts with heavy involvement in the KLSE. Mahathir himself directed the expansion of government participation in the stock market in the late 1990s and early 2000s as yet another way to increase the wealth flowing to Malays in the wake of the country’s financial crisis. Besides the unit trusts that had existed for years before Malaysia’s crisis (Amanah Saham Nasional and Amanah Saham Bumiputra), the government subsidiary Permodalan Nasional Berhad (PNB) launched two more in 2000 and 2001. PNB also manages four unit trusts open to all Malaysians, including Amanah Saham Wawasan 2020 (launched in 1996) and three others launched between 2000 and 2003. But even the pan-ethnic government unit trusts reserve many shares for bumiputras at discounted prices.

Besides PNB’s capital market investments, the government maintains an active interest in the corporate world in other ways. Khazanah Nasional Berhad, incorporated in 1993 under the Ministry of Finance, undertakes “strategic investments” in areas such as power generation,

35 “Priority on acquiring a first-class mentality,” The Star, April 1, 2006. One interesting development is that for the first time Indian Malaysians have been identified as requiring government assistance, “9th Malaysia Plan: Yearly economic growth of 6 pc,” New Straits Times, April 1, 2006; “Business training for Bumiputeras and Indians,” New Straits Times, May 23, 2006.
shipping, transportation, and many others. Perbadanan Nasional Berhad (PNS), formerly under
the Ministry of Finance before privatization in 1996, facilitates the growth of a “bumiputra
commercial and industrial community” by investing in bumiputra-controlled start-ups and
distributing franchises to bumiputras. Perbadanan Usahawan Nasional Berhad (PUNB), a
wholly owned subsidiary of Yayasan Pelaburan Bumiputra (of which PNB is another
subsidiary), has since 1991 complemented PNS in nurturing bumiputra entrepreneurs, and its
responsibility for creating bumiputra franchisees and businesses owners expanded notably in the
Ninth Malaysia Plan.36 Below the federal level, State Economic Development Corporations
(SEDCs) perform similar functions within most Malaysian states. A wide array of government
linked coordinating bodies and policy development organizations support these efforts both at
the Federal level and among the Malaysian states.37

The principal-agent danger from such extensive government involvement in the
Malaysian business sector is precisely the same today as it was a decade ago. PNB, Khazanah,
PUNB, the SEDCs, and even PNS are all subordinate to politicians, and despite Abdullah’s vocal
commitment to efficiency and “the national interest,” the politicians that oversee these
government bodies may have interests at loggerheads with that of the Malaysian people, the
firms’ supposed beneficiaries. In the past, politicians have influenced national investment
companies to invest in uneconomical business ventures connected to political allies.
Additionally, because the regime has such a direct stake in the performance of Malaysian stocks,
it has a strong incentive to protect dividends at all costs. From the perspective of the recipients
of patronage, political favoritism breeds moral hazard. And while many governments across the

world have quasi-corporate subsidiaries that facilitate strategic national investments, the danger in Malaysia comes from the country’s weak regulatory apparatus.

Regulatory weaknesses are the result of technical incompetence, but rather of the vulnerability of supervisory agencies to political interference. Bank Negara Malaysia, Malaysia’s Central Bank, is by no means independent from political influence (during the 1998 crisis political pressure led its Governor and Deputy Governor to resign). Agencies of public accountability such as the Anti-Corruption Agency (ACA), the Federal Courts, and the Electoral Commission (EC) remain subordinate to high UMNO office holders. The ACA has the statutory authority to investigate and prosecute a wide number of offenses among public servants, but in practice, it is successful against only low-level functionaries. The Malaysian judiciary, stripped of independent authority by Mahathir in the late 1980s but tentatively reasserting its independence since 2004, still under Abdullah faces not infrequent accusations of bowing to political pressure and bribery. The Electoral Commission still encounters widespread criticism from opposition parties and NGOs, most recently for shady voter registration practices in Sarawak’s 2006 state elections. In the 1980s and 1990s, such weak regulatory bodies fostered the growth of corruption and money politics, and observers uncovered a number of corporate scandals tied directly to UMNO and other BN component parties (see Gomez 1994; Gomez and Jomo 1999; Milne and Mauzy 1999; Searle 1999). During the crisis, Mahathir used these and other investment arms to protect the interests of favored groups, using for example funds from Khazanah and the publicly owned pension fund the Employees’ Provident Fund to shore up the

38 “First civil servant to be charged with not declaring assets,” New Straits Times, February 14, 2006; “At the Dewan Rakyat yesterday: arrests for graft increasing,” New Straits Times, March 21, 2006.
sagging KLSE.\textsuperscript{41} In other words, without prudential oversight, Malaysia’s economy in the 1990s expanded recklessly, leading to macroeconomic vulnerabilities; today, without meaningful reform, the same danger exists.

Several recent corporate scandals reveal that political protection remains valuable for well-connected corporate figures. In the case of Daim Zainuddin, his falling-out with UMNO power holders appears to have left him particularly vulnerable. In January 2006, the Court of Appeals ruled that Metramac Corporation Sdn Bhd (formerly Syarikat Teratai K.G. Sdn Bhd), controlled by Daim’s protégés Halim Saad and Annuar Othman, owed RM65 million to Fawziah Holdings Sdn Bhd for losses incurred in a scrapped highway construction project from 1990. Daim as Finance Minister had informed the directors of Fawziah—a main investor in Syarikat Teratai—that the government had insufficient funds to pay compensation for the project. Halim and Annuar then purchased Syarikat Teratai for a deflated price, after which Daim announced that the government would pay the compensation after all. The key to this transaction was Halim and Annuar’s personal connections to Daim, which allowed them to make tens of millions of ringgit instantly at Fawziah’s expense.\textsuperscript{42} Halim, Annuar, and Daim immediately appealed court’s ruling, and Daim firmly denied that Halim or Annuar had ever benefited from connections with him during his tenure as the Minister of Finance.\textsuperscript{43} This statement certainly conflicts with the many questionable contracts awarded to Halim’s United Engineers (Malaysia) Berhad, a subsidiary of Renong (see above), throughout the 1980s and 1990s (Gomez 2002: 91-95; Jomo 1998: 187). The case has yet to reach a conclusion, but it is revealing that the case against Daim moved forward only after he fell from political favor.

\textsuperscript{41}``RM60b sokong BSKL,’’ \textit{Utusan Malaysia}, September 4, 1997.
\textsuperscript{42}``Metramac to pay RM65m,’’ \textit{New Straits Times}, January 13, 2006; ``KL politics-business link exposed in court,’’ \textit{Straits Times}, January 16, 2006.
\textsuperscript{43}``Daim: it was Cabinet’s decision,’’ \textit{The Star}, January 27, 2006.
Under Abdullah, moreover, political scandals reveal also that the practice of UMNO politicians using their office for corporate gain remains widespread. In 2005, Mahathir revealed the extensive use of approved permits (APs) for importing foreign-made automobiles into the country as important new tool of political patronage. The distribution of APs falls under the authority of Minister of International Trade and Industry Rafidah Aziz. Mahathir, as Proton’s advisor, condemned the practice for introducing competition to Malaysia’s heavily protected domestic automobile industry, and released the names of the beneficiaries of over 67,000 APs issued in 2004 alone. Despite extensive media coverage, no charges of wrongdoing have been filed, and Rafidah has retained her position.\textsuperscript{44} In another scandal, the Malaysian press revealed in May 2006 that UMNO parliamentarian Mohd Said Yusof had requested that Malacca Customs and Excise officials “close one eye” to the import of illegal Indonesian sawn logs by a company that he owned. This is not Mohd Said’s first brush with the authorities over illegal trade, as customs officials in 1999 charged a company of which he is a director with illegally exporting pirated VCDs to Indonesia. Yet even though Mohd Said admitted abusing his political power, the BN refused to endorse an opposition recommendation to refer Mohd Said to the Parliamentary Privileges committee.\textsuperscript{45} These political developments lead most observers to question the true extent to which Abdullah is able to combat corruption and patronage in Malaysian politics.

So in contrast to the case of Indonesia, in Malaysia we find that institutional continuity has contributed to a more rapid recovery from the crisis, at the cost of continued if not additional macroeconomic vulnerabilities. The link between Malaysia’s political system and

\textsuperscript{44} “Committee fully responsible for APs, says Pak Lah,” \textit{The Star}, February 18, 2006.

Macroeconomic vulnerability is easy to miss in relatively fat times, but it is important to recall that Malaysia’s economic crisis from 1997-1999 began following a similar period of seemingly healthy expansion. Like Indonesia, though, the memory of the near-collapse of Malaysia’s economy still gives foreign investors pause, and risk consultancies continue to warn that the dark areas of Malaysia’s political economy have persisted under Abdullah. If anything shields Malaysia from financial and real sector crises today, it is investor wariness, not political and economic reform.

5. Conclusions

The experiences of Indonesia and Malaysia after the Asian Financial Crisis reveal the difficulty of establishing institutions that can sponsor healthy economic growth. Indonesia since 1998 has experienced rapid and far-ranging institutional change towards institutions that scholarly consensus holds should be both welfare and efficiency enhancing. But its experience suggests that the benefits of democratization and decentralization can be delayed, both by extensive corruption and the difficult task of adjusting to these new institutional arrangements. Malaysia’s experience reaffirms what many consider an uncomfortable common wisdom that despite their high costs in terms of personal freedoms, selective repression and autocratic political stability can be a platform for economic recovery. In both countries, corruption and government-business linkages remain the greatest source of macroeconomic vulnerability, and the level of corruption in 2005 in each is the same as it was before the Asian Financial Crisis. But corruption has changed in Indonesia from a highly centralized system of hierarchical exchange to a decentralized system of bribery and influence peddling. In Malaysia, the main players have changed with the resignation of Mahathir, the marginalization of Anwar and Daim, and the rise of Abdullah and Khairy, but the system has proven remarkably resilient.
If the discussion here appears pessimistic, one welcome sign in both countries is the rise of an active civil society. Civil society in these two countries plays a vital role in monitoring government excesses and agitating for reform. Hundreds of NGOs have sprung up in Indonesia to agitate for clean government, such as the influential Indonesian Corruption Watch which has taken the lead in tracking and publicizing cases of corruption. In Malaysia, draconian legislation that restricts civil society organizing remains in effect, but opposition presses and NGOs energized by the country’s reformasi movement still vocally criticize the BN regime, and even the government-controlled print media have become bolder in covering political and economic scandals since 2004. While evidence of its impact on policies that minimize macroeconomic vulnerability remains scarce, the ability of nascent civil society groups to help improve government accountability to popular demands for clean and responsible government may be the key to fostering macroeconomic stability and healthy long-run economic growth in Indonesia and Malaysia.

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