The Iniquity of Globalization

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Abstract

Globalization, the twentieth century buzzword, has mutated into a 21st century nightmare – the global economic crisis. Globalization refers to the greater interconnectedness among nations. It is also seen as the implementation of socio-economic policies which gave priority to market forces while the state takes on a diminished role. Opening up to international trade has helped many developing nations achieved economic growth. Financial liberalization, part of the globalization process, resulted in unprecedented growth in financial institutions and financial products. However, globalization has not brought the promised economic benefits of efficiency and equity; instead there was a widening of income inequality. The 1997 East Asian financial crisis (EAFC) and the recent global financial crisis highlighted the weaknesses of globalization: increased instability and iniquity of economic progress.

Keywords: Globalization, Financial Liberalization, Credit Allocation, Financial Instability, Contagion

1. INTRODUCTION

Globalization is seen as the implementation of socio-economic policies which gave priority to market forces while the state takes on a diminished role. According to Baker, Epstein and Pollin (1998) globalization entails a step-up in the level of economic interaction between different countries leading to a qualitative shift in the relationship between nation-states and (national and international) markets. It was primarily in the 1980s when globalization gathered momentum, that led to the development of global cities (or world cities). The mark of a global city is its disproportionate share of finance and business service headquarters (Sassen, 2006). Global cities constitute “strategic sites” in which leading-edge global functions are performed. Friedmann (1986), view this urbanization process as intricately linked to global economic forces and that the world cities are the ‘basing points’ for global capital. Similarly, Fanstein (2001), attributed the increasing deregulation of financial markets, privatization of industry that occurred in the wealthy world cities of New York, London, Tokyo, Paris and the Ranstaad to the consequences of global economic forces. The pro-globalization fraternity views it as a positive development for mankind as they perceive the globalization process as opening doors to more opportunities. However, with globalization, industrialized countries experienced declining employment and widened income inequality. While for many developing countries, globalization has not brought the promised economic benefits.

2. GLOBALIZATION AND THE ECONOMY

The most visible aspect of globalization is globalization of the economy. Globalization has been made possible with the liberalization of trade, foreign direct investments and capital flows. The resultant economic changes arising from the hive of economic activities have been radical in both in the developed and developing countries. In the developed countries, three economic sectors; namely, banking, insurance and specialist services have flourished in response to
the internationalization of transactions. The economic structure of global cities in the developed countries had lead to social polarization. This is due to the fact that the leading sectors are the business and services sectors; thus this shaped the types of occupations in these cities: a dichotomized labor force. On the one hand, professionals specialized in control functions and on the other, a vast pool of low-skilled workers who are employed in the personal services and the hotel and tourist industries that cater to the privileged classes (Sassen-Koo, 1984, cited in Friedmann 1986). As for the developing countries, opening up to international trade has helped them achieved economic growth. Export –led growth was the centerpiece of the industrial policy that had enriched a number of the Asian countries. However, to many of these nations, the promised economic benefits have not materialized. There is a growing divide between the haves and the have-nots. While liberalization of financial sectors has resulted in financial instability becoming more widespread. The liberalization of the banking sector of most developing countries (like Malaysia), has been spurred by the seminal works of McKinnon (1973) and Shaw (1973). They advocate financial liberalization and development as growth enhancing economic policies. Financial liberalization advocates reduced direct intervention of the state in the economy and advocate instead, a market-oriented economy using price mechanism to allocate resources. According to liberalization theory, when interest rates and credit allocation are market determined, efficiency in the financial sector is raised, thus help ensure that the more productive investments are financed. They provided convincing theoretical ground to advocate a finance-led development strategy.

3. FINANCIAL LIBERALIZATION IN MALAYSIA

Financial liberalization was introduced in Malaysia on October 1978. According to Awang Adek (1994), the freeing of interest rates was a conscious policy measure by Bank Negara Malaysia (BNM) to promote a more liberal and competitive financial system. With this move, the commercial banks were free to set interest rates for deposits of 12 months and less, as well as the prime lending rates. However on several occasions, the deregulation process had to be put on hold or reversed when the economy faced adverse shocks. For example, the protracted global economic recession in the early 1980’s affected Malaysia’s economy adversely. Market determination of interest rates was suspended during the tight liquidity period from 1985 to January 1987. On October 21, 1985, all banks were required to tie their respective deposit rates (for deposits of up to 12 months maturity) to not more than 0.5 percentage points of the rates offered by the two leading domestic banks. This arrangement was dismantled in February 1987. However, in September 1987, BNM re-imposed control on the interest rates yet again. This time the restriction applied to the base lending rate (BLR). Commercial banks’ BLR were required to be no more than 0.5 percentage points above the BLR of the two leading banks. The margin by which lending rates can exceed the BLR was limited to four percentage points. This arrangement remained in force until February 1, 1991 when the BLR was freed from the administrative control of the central bank, Bank Negara Malaysia. From February 1, 1991 onwards, each commercial bank can set its own BLR according to its own cost of funds. Except for interest rates on limited priority sectors lending, market forces freely determined all other interest rates. Commercial banks were allowed to declare their own BLR subject to a ceiling rate calculated in reference to their own cost of funds, including the cost of maintaining statutory reserves, meeting liquid asset requirement, staff and overhead costs, but excluding cost of provision for bad and doubtful debts. This BLR framework was intended to create a new interest rate regime whereby both deposit and lending rates would be determined by market forces besides being more responsive to liquidity conditions. This move was aimed at fostering greater flexibility for banks to pursue their own lending strategies. This framework was further liberalized in 1995. With effect from November 1995, each banking institution was free to quote its own BLR at any level subject to an industry ceiling rate which was determined in relation to the three-month inter-bank weighted average rate of each month.

The policy framework laid by the nation’s first Industrial Master Plan (IMP) and the subsequent liberalization and deregulation of the economy after the recession years of the mid 1980s provided the foundation for rapid growth of the manufacturing sector (Bank Negara Malaysia, 1999). The manufacturing sector has played a significant role in various aspects of the Malaysian economy (in terms of contribution to export earnings and employment). Bank Negara Malaysia recognizes that a sound and strong financial system is a necessary pre-condition for steady economic and social development in Malaysia. In this regard it has consciously developed a modern and sophisticated financial system to mobilize and allocates the country’s resources for productive use. Financial liberalization introduced in 1978 was said to be a step towards this goal.
4. FINANCIAL LIBERALIZATION AND CREDIT ALLOCATION

As is the case for most economies, banks are the major suppliers of credit to finance productive investments and other debt-financed activities. Shanmugan (1988) found that bank credit played a major role in the operations of the Malaysian public listed companies investigated; while the econometric analysis by Tan (1995) revealed that bank credit exerts a positive and significant influence on economic activity and that the causal relationship between the two variables is unidirectional, i.e., from bank loan to economic activity. The growth and availability of bank credit had always been a cause for concern. Reduced credit by banks can cause a ripple effect on total credit available in an economy. This is reasoned out as follows: reduced credit by banks has a direct effect on firms; besides that, firms themselves are “banks”; as they provide credit to their customers and suppliers, which would also be affected. Thus the reduction in credit by a bank has a multiplier effect on an economy (Stiglitz, 1992). This scenario has been played out in the 1997 East Asian Financial Crisis. In Malaysia, many firms experienced tight credit conditions when banks decided to lower the amount of overdraft facilities, or withdraw altogether, the facilities provided earlier. Bankruptcies among the small business entrepreneurs were widespread due to the credit squeeze. The recent credit crunch that arose from the global economic crisis is another testament to the importance of credit availability.

Proponents of financial liberalization stressed that deregulation will result in more efficient credit allocation. There are many econometric studies that showed increased allocated efficiency of investment after financial liberalization has occurred. Saint–Paul (1992) cited in Williamson and Mahar (1998) found that the gains from increased financial development stemmed from increased efficiency in the allocation of investment rather than from a larger volume of investment. However, in developing countries, financial liberalization often changes significantly the sector allocation of credit; typically the shares of services sectors, consumer loan and property related credit tend to increase at the expense of industry (Akyuz, 1993). Atiyas (1992), cited in Caprio, Atiyas and Hanson (1994), found evidence, that in Korea; credit flows moved from light industrial manufacturing to services, utilities and construction after financial liberalization had occurred. Alba (1999) pointed out that financial liberalization could lead to a generalized surge in bank lending and greater banking exposure to the real estate sector.

An analysis on the growth and direction of commercial bank loans from 1975 to 2003 in Malaysia is given here. The aim is to ascertain if the sector allocation of credit has changed after financial liberalization was introduced in Malaysia. Table 4.1 tabulates the percentage of loans given out by the commercial banks to the various sectors in the Malaysian economy from 1975 to 2003. These figures indicate that there was a surge in lending as a result of financial liberalization in Malaysia. When financial liberalization was first pursued in 1978 (with the removal of some interest ceiling rates), high loans growth rate was registered in the 80’s, especially in 1980 which registered the highest growth rate (year to year) to date. This lending boom was interrupted by the economic recession of the mid 1980s especially during 1985-1987. Financial liberalization was put on hold or even reversed since being introduced in 1978, as explained earlier; it was only in 1991, that there was full deregulation of lending rates. With full deregulation, there was once again a surge in bank lending in the years leading up to the East Asian financial crisis (i.e. from 1995 to 1997).

Charts for the share of the loans secured by 9 major economic sectors in Malaysia are shown below. From Chart 4.1, it is quite obvious that the broad property sector took the largest share of the loans given out by the commercial banks. The trend line fitted for the broad property sector (Chart 4.3) shows that the increase (in percentage) over the years is quite steep. The share of loans secured by the manufacturing sector remained almost unchanged after financial liberalization was introduced. Chart 4.1 shows that the share of loans secured by the other two sectors (Transport & Communication sector and the Finance, Insurance and Business Services sector) are lower than that of the manufacturing sector. However, the rate of increase in the former two sectors is much more significant. This implies that the allocation of credit to the two service sectors have increased substantially compared to the manufacturing sector.

Chart 4.2 shows that three sectors experienced decreasing shares in the loans obtained from the commercial banks, namely the wholesale, retail & hotel sector, agriculture sector and mining & quarrying sector. On the other hand, consumption credit, stock & shares sector saw their shares of loans increased over the years. Hence it can be observed that financial liberalization did affect the sector allocation of credit in Malaysia. The share of service sectors, consumer loans and property related credit increased at the expense of industry. As noted by Tan (1995), the
dramatic pick up in the lending activities of commercial banks during the post liberation period is somewhat consistent with the McKinnon-Shaw hypothesis of financial liberalization. However, increased lending is not

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<th>Manufacturing</th>
<th>Electricity</th>
<th>Wholesale retail &amp; Hotel</th>
<th>Transport, Storage &amp; communications</th>
<th>Financing, insurance and business services</th>
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Source: Monthly Statistical Bulletin; Bank Negara Malaysia, various issues
Table 4.1: Loans and Advances According to Sectors (in percentage) (continue)

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Source: Monthly Statistical Bulletin; Bank Negara Malaysia, various issues
Chart 4.2: Loans Secured by The Agriculture, Mining & Quarrying, Retail & Hotel, Stock & Shares and Consumption Credit Sectors

Chart 4.3: Trendline for The Broad Property Sector
necessarily a positive development. In fact, deregulation may make matters worse by causing the system to respond more flexibly to bad signals. Examples - Chile’s excessive investment in real estate in the 1980s (World Bank, 1990), Malaysia’s excessive lending to risky projects in the mid 1990s. (Corsetti et. al., 1998) and of course the US property boom in the last decade or so. With the liberalization of interest rates, banks and other financial intermediaries have more freedom of action, hence increasing the opportunities to take on riskier projects in return for higher profits.

5. GLOBALIZATION, CONTAGION AND INCOME INEQUALITY

Economists at the IMF had created a database that tracks financial crises over the last 30 years. The number of crises that occurred during that period is an astounding 124, and these crises usually occurred in the banking, currency or sovereign debt sectors. Financial liberalization and the increase in global capital flows is seen to have contributed to the rise in these crises (Newsweek, 2008). A number of empirical studies have also found that liberalization of the financial sector has contributed to the banking crises in a number of countries including the 1997 East Asian Financial Crisis (Demirgic-Kunt and Detragiache, 1998, Cole and Slade, 1998, Zhuang, 2002 and Yee, 2004 and 2008). The five economies that were worst hit in the 1997 East Asian financial crisis (EAFC), namely, Korea, Indonesia, Philippines, Thailand and Malaysia had liberalized their financial sector sometime before the onslaught of the banking debacle. Yee (2004, 2008) found that financial liberalization, bank lending rates and the ratio of M2 to foreign exchange contributed to the Malaysia’s banking crisis in 1997-98.

Contagion has become more common with the advent of globalization. For instance, a crisis that started in Norway, Sweden and Finland spread contagiously to the European countries in 1992-93. Then in 1994-95, the Mexican crisis erupted, followed by the Latin American crisis. Closer to home, the collapse of the Thai baht on July 1997 caused the contagion in East Asia. The turmoil and chaos were not localized to East Asia. The EAFC induced a decline in global demand, which in turn led to slow down in social investments in Latin America and a sudden rise in the cost of imported medicine in Africa (Bende-Nabende, 2002). Last, but not least, “the contagion of the century” - the global economic crisis. This crisis began in the “sub-prime” housing mortgage sector in the United States. It then spread to the banks which had invested in financial instruments linked to the value of these sub-prime mortgages. When news of a fire-sale of one of the largest and oldest banks in the US, Bears Stearns Inc.; was announced on March 2008, global financial stocks plummeted.

The 1997 EAFC and the recent global economic crisis highlighted the weaknesses of globalization: increased instability and the iniquity of economic progress. During economic prosperity, the rich and the wealthy gets the lion
share of the wealth. However during the downturn, the more vulnerable segments of the population (such as farmers, small business entrepreneurs and wage earners) and in general, those who had no role in bringing about the crisis bore the brunt of the burden and hardship. During the EAFC for example, millions of people lost their source of livelihood (Yellen, 2007). Bankruptcies among the small business entrepreneurs were wide spread due to the credit squeeze brought on by the onslaught of the EAFC. There was not enough food, medicine or milk for the children; while civil unrest and street demos with looting became common (Mahathir, 2002). Mahathir had stressed that globalization can bring benefits but only if it is given a human face and that a globalized world would be meaningless unless it is an enriched and an equitable world. During that crisis, the country’s respective government and central bank had to intervene to help stabilize the economy. As noted by Stiglitz (2002); that for a while, in 1997 and 1998, the EAFC appeared to pose a threat to the entire world economy. Similarly, in this recent global economic meltdown, governments had to pump trillions of dollars into the economies in order to stem panic and to prop up the financial systems (The Economist, 2009). In this crisis too, ordinary folks are the most badly affected, so as to prompt such statements as:

“Free trade means moving away jobs” and “What economic recovery? Recovery is only for the rich” (CNN.com/Caffertyfiles, 2009)

A common denominator in New York and London, is the shift from industrial to service employment and also the shift of manufacturing jobs to East Asia and other semi-peripheral locations (O’Loughlin and Friedrichs, 2002). Thus, to these workers who lost their source of livelihood, globalization is not a positive development. Other growing cities experience a similar economic fate as globalization processes change the character of the national and local economies. In developing countries on the other hand, there’s increased employment; brought about by the opening their economy. Opening up to international trade has helped many countries grow and deregulation of financial sectors has resulted in an unprecedented growth in financial institutions, financial products and also economic growth. Yet, available data indicate that income distribution in a number of Asian countries has become more unequal in recent years (Medhi 1994). His findings have been corroborated by the World Bank (1998), which shows that inequality has risen in China, Hong Kong, Thailand and the Philippines. The World Bank attributed this rise to two factors; firstly, a rise in returns to higher education which has driven a wedge between the earnings of skilled and unskilled workers and secondly, the concentration of economic activities in certain areas, mainly urban; which has led to regional income disparity. According to Bende-Nabende (2002), by the late 1990s, one fifth of the world’s people living in the highest-income countries had:

86 per cent of the world GDP; the bottom fifth just 1 per cent.
82 per cent of the world export markets; the bottom fifth just 1 per cent.
68 per cent of foreign direct investment; the bottom fifth just 1 per cent.

6. CONCLUSION

Contrary to theory, globalization did not result in efficiency and equity for the countries that had joined in the global system. Financial liberalization, part of the globalization process did not lead to increased efficiency in the credit allocation process for the case of Malaysia. The share of service sectors, consumer loans and property related credit increased at the expense of industry. The dramatic pick up in the lending activities of commercial banks during the post liberalization period is somewhat consistent with the McKinnon-Shaw hypothesis of financial liberalization. However, increased lending is not necessarily a positive development. In fact, deregulation may have made matters worse by causing the system to respond more flexibly to bad signals. Besides, liberalization has been linked to an increased fragility of a country’s banking system. With the liberalization of interest rates, banks and other financial intermediaries have more freedom of action, hence increasing the opportunities to take on riskier projects in return for higher profits. The recent global economic crisis that had its roots in the “sub-prime” housing mortgage sector in the United States is the latest case in point.

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8


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