

THE CURRENT GLOBAL CRISIS: THE PERILS OF ECONOMIC GLOBALISATION*

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The basic foundation of this crisis actually lies with the global economic system which is based on the globalisation of the economy and financial systems. That is the foundation of the current problem.

However, if we actually look at the system, this crisis is not about a specific country or specific factor. It is actually about the global system which is based on the economic globalisation system. The question that comes to mind with that statement is that, will this happen again? In my opinion it will happen again. So, this is not the final crisis, and since it is not the first crisis, it will happen again. Based on the one that we had, let us get to the content. There will be three parts to this discussion. The first one is the causes of the crisis. The second one is the impact, and the third one is the future of the economic globalisation.

Is the 2008 crisis a repeat of the 1998 crisis? In fact yes, and in between, the world has seen so many crises but the big crisis happen in 1932 when the whole world was in depression. Then, we have the present crisis. These are the two major crises that involved the whole world. In between we have many crises. For example in 1992, we had the Mexican crisis, in 1998 we had the Asian crisis, in 2001 we had dot com bubble crisis, and so forth.

The difference between all the crises is the degree of the sovereignty. For some, it is restricted to some countries and some of it is regional. The only noticeable characteristic is that a crisis now occurs more often. Previously every 12 years, and then every 10 years. Now it is happening more often because the global economy is so integrated. So, if you look back and you see this pattern, this is what is going to happen.

* This paper was presented as Keynote Speech at the Seminar of International Journal of Management Studies on July 25, 2009, organized by Penerbit UUM in collaboration with the IJMS Editorial Board and Faculty of Economics and Muamalat, Universiti Sains Islam Malaysia

All crises are not the same, so therefore the two crises in 1998 and 2008 are different. In 1998, it started in East Asia because East Asian countries were in trouble, but the rest of the world was doing well. The Asian countries can recover quickly; we had “V” shaped recovery because we can export ourselves out of crisis. But the problem now, the mother of all the economies in the world, the United States, is in trouble and export has gone down. So it is very difficult to export our way out of the crisis. So, the 1998 crisis also began with the financial market. In this case, it was because of the short term capital outflow, but the 2008 was a bigger crisis. It was started by the global financial system, thus both were started by the financial sector. However, one is a short term capital flow, the recent one was actually the financial system itself. So, because of that, it is a systemic problem, and the 2008 crisis is much more difficult to overcome.

So let us recap on the factors of 1998 crisis we are looking at the Malaysian perspective. So, the 1998 crisis was actually initiated by external factors. It did not begin with a factor in Malaysia, but the domestic situation at that time made it worse. So, what are the external factors? At that time, there was influence by economic and financial developing institutions. So, capital workflow was not regulated properly and the capital flow moved out very quickly from country to country. Liberalisation was done quite fast. There was not enough safeguard put into that liberalisation and it was triggered by the attack of currencies and it cause short depreciation of currency. I would not want to use the word ‘*speculators*’ since these are sometimes currency traders. I mean it is their business to make money. So, they saw the difference of the availability or that some countries are not able to defend against the exchange rate because this country has a pack exchange rate like Malaysia, Thailand, Indonesia, and Korea, and they do not have enough reserved deficit. So, they know, the currency traders and speculators know this currency cannot be defended, so they attack the currency. Once the attack came, everybody behaved the same and everybody wanted to get out, so this is what they called the “Herd-like behaviour”. So, market confidence was lost. Now, why did the internal situation make it bad? I mentioned before—the pack of the Ringgit—so people knew that we could defend that Ringgit and then there was the current account deficit because our import was much larger then our export including trade and capital accounts and then we have high investment. The economy was overheating at that time. So, we saw prices of houses going up. Some of the characteristics found in this crisis and also the current crisis is that there was mismatch of currency and financing maturity, which means that companies finance long term projects with short term capital.

Now, what is the cause of the beginning of the present crisis? As we know, this crisis began in the United States when the sub-prime loan problem emerged, but if you look back, this crisis actually began in 1970. Presently, 2007 was the trigger point, but the development of that crisis started in 1970 and the whole thing became what it is. The global system becomes what it is because there is no global imbalances, a huge economic and financial changes or gyration. This is what some people or some economics call "the casino economy". Economic activities are not based on real activity. It is based on speculation. Actually capital moved around the world so quickly but the starter was actually the financial sector. It is the financial sector melt down which spread to the real economy. So, actually, the real economy was doing well. So, why did I say it started in 1970? It began when President Nixon at that time suspended the US dollar convertibility into gold that means that the end of the Bretton Woods system of pack exchange rate. Before 1972, all the exchange rates in the world were packed. But when Nixon did this, then you have the floating exchange rate. Now why did Nixon suspended the US dollar convertibility to gold? If one remembers this is the period of the Vietnamese war. US needed money to finance the war; it cannot produce money because it was in gold. It must be bagged in gold.

So, in order to finance the war, it needs to bring actual money, which was why they severed the link between dollar and gold, thus they do not have to have enough gold to print US dollars. So, once you have the floating exchange rate, currency began to move, but more importantly the US dollar became the only reserve currency in the world. Even now, if you go with the US dollar, it is accepted everywhere. So, the US government can print as much dollars as it wanted, and the world will accept it. So, that began this whole imbalanced data. But that was alright because the economic globalisation was slower, but in the early 1980s there was another movement promoted by Professor Milton Friedman. This was about the free market economy where Prof. Essor Friedman said that the government should take a back seat and let the private sector drive the economy and together with that, the idea of financial liberalisation, because in order for the market economy to expand and to grow, we must have free capital movement. So, you must have liberalisation of the financial sector and then at the same time there was the ideas of Ronald Reagan and Margaret Thatcher, who believed that the free market will bring good economics again and introduce the concept of privatisation. Later, they had the regulation of the financial market and that is where you find all this money and changing currency. To the extent in the stock market, what happens in Dow Jones can, not even the next day, maybe even 10 minutes later,

be observed to influence the Kuala Lumpur stock exchange which will react accordingly. So, this is the beginning of the crisis. So it takes more than 40 years for this crisis to happen.

So, in general let me summarise the causes of why the global financial system had melt down. There are these imbalances and bubbles. The imbalance is one because the United States consume and the rest of the world, particularly East Asia, saves. You know saving is supposed to be a good virtue, a good characteristic, but in this case it is not so good because what we save, America spends. That is why people also blame East Asia, "why don't you spend your money"? So that is the big debate now. Do not save too much. East Asia must spend. You know we work hard and spend. You know, the Chinese have US\$2 trillion reserved. What does the Chinese do? Save all the money in America and now they are worried because the US\$2 trillion savings might diminish in value if the US dollar depreciates. So, the Chinese also cannot be hard on America because if they are hard on America, America may devalue its currency. That savings will go down. So, that is the imbalance. The other imbalance is because of energy producing countries. The Middle East, the Saudi's have everything and they also have large surpluses but where do they save? They save in America and in Europe. These are financial savings. Now, who invests this money? Who invests this savings? Besides the US treasury, it is the H1, the private equity. So, they take this money, they go and invest in developing countries. In stock markets, they invest in commodity in order to get quick gain. So that is why you see prices of all stocks increased so much; the prices of mineral and everything. So, it is the imbalances and the fact that we failed to invest this savings properly, and also we have this financial reengineering. You know, before this crisis, the best students in Europe and America actually do not go to the Medical faculty; they do not go to the Engineering faculty. They go to study finance. Those are the best students. Here, we encourage our best students to do medicine. In America, no, they go to finance because this is where they can make money. So the financial sectors attract the best brains and because of that they can do, thus this is financial engineering.

All this model is to raise everything and come out with new instruments which in the end, nobody knows how risky it was. So because of that, they can create a lot of financial instruments that people buy without knowing the risk. So, when they burst, buyers get zero. So, that is the problem why Malaysia is packed or East Asia is packed from this crisis because we are not too clever. We are not clever enough to understand this instrument, so we do not have them, so that is why

we are saved. If we are clever, we buy them, we will be in trouble. So if we look at the financial houses, the kind of financing model they do is very sophisticated, because they actually get the best people to do it and then there is capital flow because of the liberalisation. You can take your money everywhere by the press of the computer button and they are not regulated. This is what they called now “a shadow financial sector” the one that causes the problem is not the regulated financial sector, it is the unregulated financial sector. The unregulated financial sector was developed by the bank because when they want to do any transactions, they are under the control of the regulations of Central Bank. So, they cannot do it. They has established what they call “special vehicles” that are not regulated. So, that is where they do all these transactions involving sophisticated instruments. So, basically, these are the factors of the global crisis melt down.

Now, was the US sub-prime loan default the trigger? To me, it is the one that actually amplified the crisis, but it is not the real cause of the crisis. The real cause of the crisis is actually the fact that with very little money, you can increase or multiply the loan that you can get and this is done through many instruments, what they call future contract, swaps, and everything I listed there through securitisation. It is done by the bank; it is done by the head fund. With one dollar you can multiply 30 times. So with very little capital, you can multiply 30 times. Now, in the US and Europe, five years before the crisis, the prices of houses went up very high. This was because the US wanted economic growth and when they want economic growth, they lower the interest rates. You might want to look now at the Taylor’s Curl. This was founded by Professor John Taylor who studied the US interest rates and showed that the US interest rates for the last 10 years during the bubble period was below what is the normal trajectory. So because of that, it created a lot of credit. You know the US at that time, if you want to buy houses, it is very easy because the agents are given a lot of incentives by the bank to sell houses. They do not care whether you have assets it does not matter. As long as you want to buy the house, you can get the credit. In the US, they have a very funny system, if you cannot pay your loan to pay for your house; you can walk away from the house. They do not look after you, they do not charge you for bankruptcy, and you can buy a house and say “ok, this month, I cannot pay the house loan, I will just locked up and walk away”. The banks do not go after you. They do not charge you. They do not take back your car. They do not do anything what so ever. So, that is what happens in the US with their system. You can walk away from your housing loan. So, everybody buys. People who have no jobs also buy houses. So, that is what happens in the US.

One of the other factor is that how do you define the risk? The issue is not the risk to the financial institutions. It is how do they affect other people. Let me give an example of the IAG. Why the US government has to rescue IAG. It is not about IAG itself. It is IAG insurance to the whole system, which is many times the size of IAG. So, if IAG goes down, it also pulls so many institutions down. So, that is another thing about this crisis.

Now, this is the week September 14 to September 19, 2008, now this is what they called “the Lehman Monday” by the Lehman Brothers. They call it now the famous Lehman Monday. This was because the Lehman Brothers were allowed to go bankrupt. Now, looking back, people are now criticising Hank Olsen, the Treasury of the Secretary US for allowing the Lehman Brothers to go bankrupt because when they went bankrupt, they owed money or extended credit to so many institutions that everybody else when bankrupt with them. Let me give you an example. When Lehman Brothers went bankrupt, there were 10,000 people in Singapore that lost a lot of money. This was because the 10,000 ordinary people in Singapore like you and me who bought the Lehman mini-bond and this Lehman mini-bond was sold by DBS, which was a very good bank. You buy each bond at about 100,000 Singapore dollars. So, 10,000 people lost their money just like that on these mini bonds. You cannot buy 1,000, you have to buy in a big sum. So, that is the impact of the Lehman bankruptcy from New York to Singapore to everywhere. And because of that, the UK banks, then Germany, and all of them had problems, but the most important reason why we nearly broke the global system is because the entire financial sector lost confidence, and they do not want to extend credit to one another. Every bank said, “Ok, I do not know whether the next guy can pay me, so because of that, I do not want to give him any credit”.

When everybody starts doing that, the whole global financial system just jammed up. Nobody can get any credit because banks have to settle their inter-bank loan everyday. The whole crop is actually the inter-bank loan. They cannot settle the inter-bank loan. So, when they cannot settle the inter-bank loan, everybody does not want to give money. So because of that the US Treasury and the US Federal Reserves, they have never done this before, actually injected money to make sure that there is money in the system. If not, the whole financial system would have broken down that way. So that week, is the famous week because it had never happened before and nobody wanted to lend any money. So it was also known as the Financial Tsunami. Most

of the countries that were affected were developed countries and not developing countries because the financial globalisation was less in developing countries.

The financial globalisation was very high in developing countries. The one that was most affected was the investment banks. There were eight top investment banks in the US. This was what they called "Cramp de la Cramp", you would know if you worked in this bank. Firstly to get that job is very difficult, but if you get that job, you are very highly paid. Now all of them are gone. Even the one that survived has to be transformed. For example Bear Stearns, which had lasted more than 100 years old, was sold to JP Morgan for US\$2 per share and before that, the share was US\$60 from US\$60 to US\$2. Now, Lehman Brothers, another 158 banks is gone, Merrill Lynch no more, and all their things are sold. The one that had survived is Golden Sach and JP Morgan, but they have to be regulated under the Federal Reserves. But the crisis has spread to the real economy. The first casualty was Cagarmas in Malaysia which was is called "Freddie Mac and Fannie Mae".

This institution gives out housing loans. Now each of them requires US\$100 billion per company to be rescued. AIG needed \$85 billion and there are bank reading more than that. Now, the most important out come of this crisis was the break down of the capitalist system. Before this crisis, if you could remember, if any other country had a crisis, the United States, a western country or a developed country would say, including the IMF, "you cannot rescue this private company that is falling". But in this crisis, they rescue everything. They rationalised everything. The US government has now become the owner of General Motors and this has never happened before. So, people would question now what would happen to the global system, especially the capitalist system.

Because of the size of the problem, the key regulators have no choice but to go in and rescue aggressively and have to perform a coordinated global financial response. So, they bailed out Freddie Mac and all those companies, they injected al lot of money, and they lowered the interest rate. Now the interest rate is 1% in the US. As Prof. Mohamad mentioned, this US increase introduced US\$700 billion and influenced the EU. So, again for the first time unlike the 1932 crisis, there is a coordinated response.

In Asia also we introduced a big physical stimulus package. In 1998, one of the reasons why the crisis was deep because we were slow in introducing the physical stimulus. This time, the world said we

must do it quickly, and luckily they did just that. But when you look at the size, Japan US\$774, China US\$586 and so forth it is significant. As percentage of GDP, it is also huge but not all this money are spec, only some are spec, some are not. But as a result, all the countries in East Asia are facing a physical deficit. Now, Malaysia has the largest physical deficit. The issue, amongst of the things, is: what are we going to do if these crises get prolonged? It will be difficult for Malaysia to increase, because we are already at -7.6% and we had been in deficit since 1998, so there is a real problem for Malaysia.

The impact – global growth is down, I think but they have revised it a bit. They said 2010 might probably be weak growth but for the first time since 1932, all the major countries in the world are in a recession at the same time, especially US, Japan, and EU. It has never been this type of a black before. This is the first time. Why is this crisis serious? Because all the three growth sectors of the world are having a crisis at the same time. Before, if the US has a problem, EU is doing fine, or Japan has a problem, the US would be alright.

Now, this is the growth estimate in East Asia. If you look at East Asia, Singapore is the worst affected, followed by Japan and Malaysia. But countries like Indonesia are doing quite well, and the Philippines is doing well. Now if you look at this pattern, one thing is very clear, a country that exports a lot suffers more. Indonesia has very little export that is why they do not experience the negative effect the same thing with the Philippines. So, this actually shows how exposed we are to the global world. If you are more exposed then you have a bigger contraction.

For the first time in 25 years, the global trade is more negative than ever before. It estimated to be about -10%. In 2009, the global trade is going to shrink by 10% again for the first time in 25 years. What does it mean to Malaysia? Malaysian export or trade is twice the size of the GDP. If world trade is shrinking, we cannot export even though we said we want to find new markets. That is a very important fact that we have to recognise.

This crisis is really what they called an “Export-led implosion” for East Asia. East Asia banks are strong. We will not be affected by the financial sector. Our banks are not in trouble, but if you look at export, Japan for six months has nearly 40% export contractions every month, Malaysia 20%, and Korea 20%. We have never seen this kind of trend before; massive export contraction. The point is this: these

are demands that have disappeared. When are we going to replace this demand? Can the domestic economy replace export? If you look at this number, the past six months minus 20% for Malaysia every month. Can we replace this demand? This is in graphic terms. This is what they called "falling off the cliff", like a waterfall, it goes down steady, but suddenly it drops down, and this is what happened in East Asia that began from October 2008.

The impact is that Malaysia has to follow the same path as any other exporting countries. Our industrial production has been contracting. For us, luckily it is only serious in October. So, the first nine months, we were alright. At that time people were saying the government was in denial because the government said everything is fine. But if you look at the number, the government is right because the number was still alright up to September, and only after October that it started contracting. Our export month-on-month has contracted, we are still has not stabilised. If you look at May, even though people thought May would be better, May was almost 30% down. However, if you look at month to month, we are showing some kind of positive numbers. It is better month to month, but year to year it was negative.

Now, this is again another impact of globalisation. If you look at commodity prices, commodity prices went from US\$30 plus a barrel to US\$145 in less than eight months. The high was in July when it actually went to US\$145 and then it went down to the lowest point, only to recover at US\$34. Now, this cannot be because of the demand. That is why people would say there is a speculation. Jim Rogers, a Fund Manager, is not speculating. He believes commodity is the play for the future because we are going to be short of commodity. So, he is buying a lot of commodity. So those of you who buy unit trust, sometimes they sell you commodity unit trust to buy all these things. So the rising price of the commodity is not because of the real demand. Some of it is because of the speculation, of course, China being the big factor. China has pushed up all the prices also, but you look up the palm oil. It went up to 2000 to double the price and now, at the lowest point, it has gone down to 1400. Suddenly, in the last three months, all of the prices have gone up again. So this is again another impact of cause and effect of globalisation. We hope that this price would stabilise at this level and would not increase higher.

Another impact of this economic globalisation crisis is the stock market. It is strange and it is unfair. The cause of the crisis is in the United States, but the biggest fall of stock market is in China. Shanghai

stock market almost went down by 60% last year, whereas for the US, it was only about 27%. It looks unfair but that is the reality. All the stock markets in emerging countries all went down much more than developed countries. This was because of invest met or having no confidence. They pull their money out. But this year, from December 2008 to May 2009, the high is May when they all went back again. Shanghai went up by 43% so, this is really a casino economy. In one year its goes down 60% in five months it has gone up by 40%. Now the question is this, how do you manage an economy in a situation like this? It is a very difficult and complex thing to handle. Stock market going up and down like yo-yo. How do you handle this?

As for the future of the economic globalization, firstly, we cannot export ourselves out of this crisis. Now, this is a popular topic: has the export left growth model dead? I leave it to you to ponder that question because what happens to export and how can we replace Malaysia? How can we replace the disappearing demand? Will such crisis occur as the present one occurs? I have answered the question. I think it will. Now, how can a small economy like Malaysia grow when there is so much volatility in the global economy? This is the survival strategy for Malaysia. The thing that we have to think about and I hope USIM will contribute to this debate is how are we going to form a strategy for the Malaysian economy. I very much welcome if you have any information, so that I can forward it to the National Economic Advisory Council. Malaysia is a small open economy. It is resource based but we have not fully moved to a high productivity economy. We have low purchasing power, but we have young population. So, Malaysia needs to produce jobs and to produce jobs at the right market and at the right rate. We do not want to produce jobs where Malaysia cannot afford, because the cost of living is quite high now. So what kind of rates? Firstly, can we create jobs. What kind of jobs at which levels? These are the major issues for Malaysia.

Now, the bigger one, this one we all cannot solve. I am just putting the question forward for you to think about, and I do not think we can solve this. Is this the end of capitalism? Is this crisis the end of capitalism? Since there was massive intervention in the market, so are we back to Keys an? Are we back to controled economy? You know, because the government is now running the economy and not the private sector, yet there is no alternative system. Over the 70 years or so, the market system and market economy are the only ones that seem to be working. The centrally depended economy has gone bust. But, how can we have a more stable equitable capital market system?

Do we need to introduce new regulations about global financial architecture? Do we need a New Bretton Woods for exchange rate stability? What is the role of IMF? And who are the new players now? Is it G8? Is it the US or is it G20? What is the role of Brazil, India, Russia, and China (BRIC)? These are developing countries but they are huge economies and will play important roles in the world economy of the future.

These are the unknown forces of the global economy, that will impact a lot of us but we do not know and we do not see them. These are the mutual funds, pension funds, assets, sovereign funds, petrodollars, and hedge funds. They are huge. Look at the number of mutual funds. It is estimated to be US\$60 trillion. Now, they can move around the world easily. You know Malaysia cannot handle this big money coming in going out. This money is everywhere. So, pension funds, move the market they save, and they move between countries, but they are not seen. Can we regulate them?

Who is the new king in this future economic globalisation? Now, I would like to give this famous quote by Deng Xiaoping. In 1978, Ding Xiaoping, the architect of the opening up of the Chinese economy, said, "only capitalism can save China". But now people say, "only China can save capitalism". So, is this going to happen or not?

Thus, everybody is expecting China to save the world. But China cannot save the world. China can save itself but China cannot save the world. Why do I say that? If you look at the world GDP, US produces 23% of the world GDP, Japan 7.8%, and China 6.8%. China imports around US 866 billion in 2008, only 1/3 of the US demand. It cannot replace US and the world engine of growth, because the China physical stimulus is as long as compared to what is lost in the market, which is about US\$3.9 trillion. China cannot compensate this, but China has resources. It has low GDP and it can actually stimulate this economy, but it cannot save the world. It can help East Asia but it cannot rescue the world.

However, now there are signs of stabilization, what they called "the green shoot". The US economic contraction has stabilised in Asia with a much better China second quarter this year, since it grew by 8%. Now that people think that its growth forecast is much better, IMF has increased GDP growth forecast by 1%. Lee Kuan Yew thinks that Singapore is going to contract by 10% this year, but second quarter Singapore GDP increased by 20%. This is the impact of globalisation.

You can go down deep and you can really go up very fast, but Singapore's performance is one-off since people think it is because of the pharmaceutical industry. Korea also has stabilised.

What is the concern on the horizon? The concern on the horizon is that although we have stabilised it does not mean we are going to recover. People are afraid that we are going to have a "U" with a long flat bottom or an "L" shaped recovery. The recent stock market activity is not an indicator of recovery. So the timing and the step of recovery is uncertain. There are many risks. One is that US unemployment is still high, housing market is not bottoming out, the financial market and banking system in US remain a problem, and there are derivatives and rising commodity prices.

Look at the correlation between economic growth of GDP growth and credit ratio for the last 70 years in the US. The correlation is very close, meaning that you cannot have GDP growth if you do not have credit growth, and the problem in the US is that the credit red-line is still plunging. So, credit has not recovered in the US. Therefore, the prospect of US recovery is quite small. Unemployment in US is still increasing. US unemployment is expected to reach 10% and this is huge. If you look at housing prices there are still falling.

What is the outlook for Malaysia? The good points first. This time, the economic difficulty is not so painful because our economy is not so overheated, so the contraction was not painful and the experience of 1998 helped us in order to move the packages quite early. But Malaysia might be in for a long period of low growth. Let us say we have 1% or 2% and we cannot afford that since we have a large physical deficit. So, the government's ability to pump the economy is quite limited. Besides that, we do not have only short term finance economic challenges, we also have medium and long term. We need to think about restructuring our economy so that we have an export oriented growth model that is more sustainable. We can have stronger domestic black growth, we can be competitive, and the private sector will lead growth once again. But underlining this, we need to get Malaysia to a high income economy, to get out of this middle income threat, but restructuring is very difficult if the economy is not expanding. So for Malaysia, there are many challenges but the biggest challenge is how to revive growth? And how to remain competitive? Because we need to make Malaysia again, with an economy that is vibrant and has strong economic fundamentals. So the challenges of the Malaysian economy is actually a lot. So, I think in this case, USIM and the faculty of economic is in the right place to contribute

to this debate and to give ideas. This issue is big and may infect all of Malaysia because the first thing people and friends that I meet say to me, "ok", you are in this council, tell us how can we have higher salary? Because we want higher salary". Because this is the big issue.