The good and the bad

aspect of financialization of economy in OIC countries

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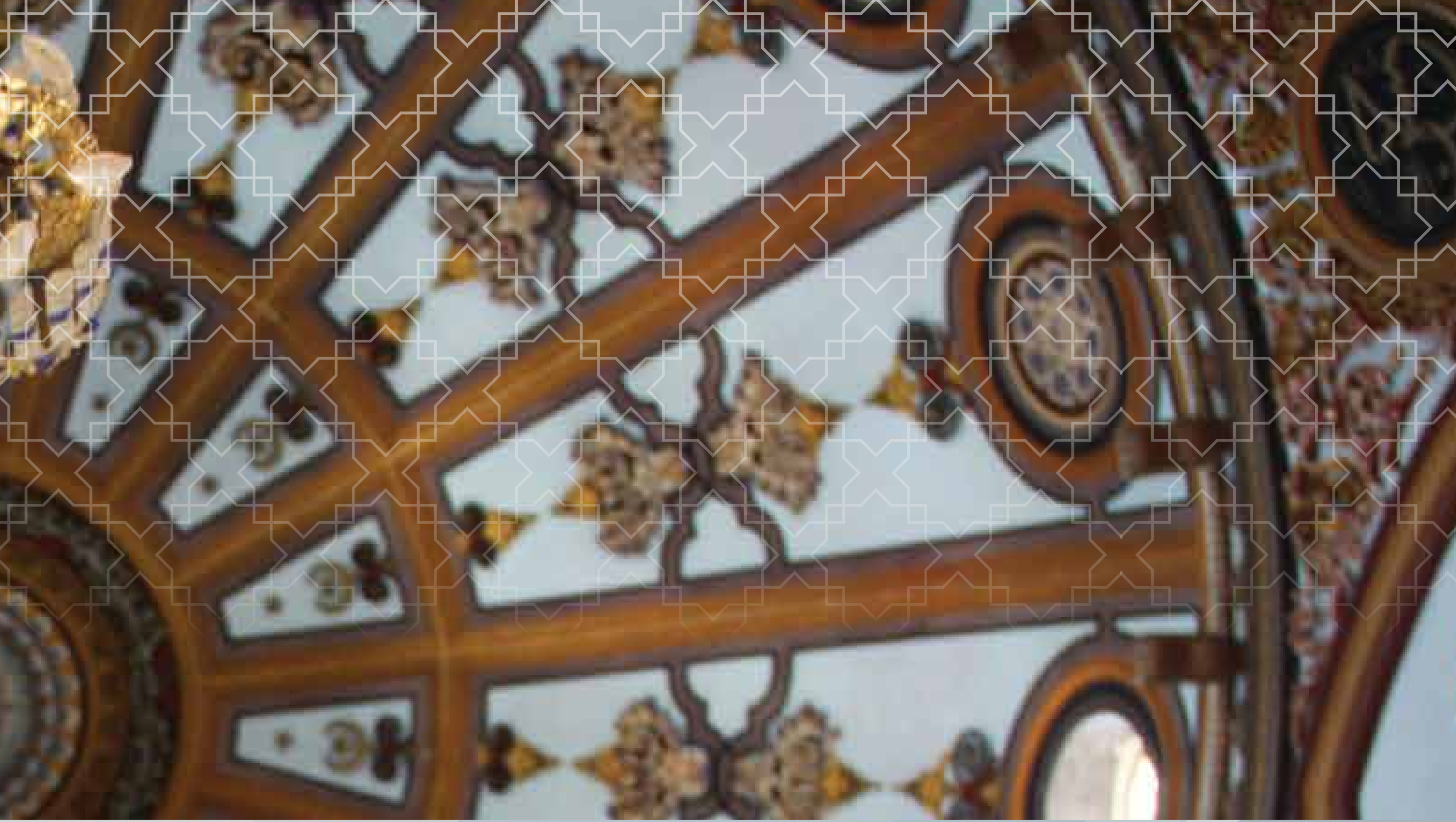
Throughout the world, the income gap between the rich and the poor continues to widen. This disparity in income has become more obvious in the last two decades as the income of the vast majority of the world's population has been somewhat stagnant over time, while small segments of the population experience an upward trend in income. In a recent report by (Oxfam 2016), it is reported that income inequality is spiralling out of control and this is a dangerous trend that poses significant threat to the global sustainability. Income inequality is not only a problem peculiar to the developed world, but also developing countries such as Muslim countries (OIC countries) as they have in recent times witnessed persistent rise in inequality.

Researchers in the field of finance and economics have identified numerous causes of increased inequality. The most commonly cited factors are: Globalization, Openness to trade, declining union power, rising compensation of top management. Recently, increased income inequality is attributed to the financialization of the economy. Financialization is defined as the much faster growth of the financial sector than in the real sector of the economy through rapid growth of debt and large increases in financial sector profits. Some of the factors that aided the spread of financialization are: deregulation of financial markets, liberalization of interest rates and shift in policy objective of economic authorities such as the central banks towards favouring price stability as against ensuring maximum level of employment which was the main goal in the past.

The deregulation of financial markets allows corporations with good credit history and collaterals to raise capital in the financial market at cheaper cost than through bank financing. This implies that corporations have self-financing capabilities, this means reduced business for the banks. This development triggers bankers (also known as rentiers) to search for alternative borrowers by lending to households and business for the sole motivation of earning profits (through charging interest) thereby transforming their strict traditional intermediation role. In addition to this, banks have also turned to the financial markets for additional money generating activities such as underwriting, investment banking (investing in the financial markets in order to earn commissions, and charging fees from underwriting exercises) and providing unsecured loans as well as mortgages. Originate and distribute model has come to replace the strict traditional banking role of originate and hold. This model has benefited the financial sector in that they no longer have to bother about the maturity of the loan advanced since it can easily be securitized and sold to a third party. This has led to the proliferation of international structured financial products that threatens the stability of the global financial system.

Since the deregulation of OIC countries' financial sector, the countries witnessed increased expansion in the growth of consumer credit markets. Since debt is a major component of financialization, banks have diversified their banking sector activities towards consumer lending and have also devised ways to induce households (through aggressive marketing campaigns) which were unfamiliar with borrowing from the financial institutions to take on credits to meet their daily financial needs. Since early 2000, household sector borrowing from financial institutions has surged in some OIC countries. One reason customers have resorted to borrowing is that labor income has not kept pace with the increasing cost of living (wage stagnation). As a consequence, they have to fill their income deficit through increased assumption of debt in order to offset stagnant wages. Serious commodification of public services has taken place: accessibility to public goods such as education and healthcare are financed with credit, which has further worsened the financial status of the lower strata of society.

There is no doubt that finance plays a vital role in the functioning of the economy particularly the real sector.



Schumpeter (1934) was among the pioneers to highlight the important role finance plays towards promoting economic development. Evidence from the literature reveals that growth of financial sector through increased liquidity in the stock market, increased competition, contract enforcement and access to financial service may contribute towards economic development by expanding investment opportunities, savings and investments and providing a risk-sharing avenue for market participants. The effects of finance on economic growth have come under scrutiny in the last two decades owing to the series of financial crisis that troubled the stability of the global economies, questioning this relationship to arrive at certain conclusions. Researchers agreed that the relationship between finance and growth is not a one-size-fits-all in nature but rather depends on the level of economic development of a particular country. For example, it is documented that high income countries such as the Unites States and Great Britain have reached a saturation point and financial development is no longer effective in enhancing investment efficiency.

Furthermore, Contemporary researchers from International Monetary Fund (IMF), Bank for International Settlement (BIS) and the World Bank (WB) have revisited these relationships and warn of the danger of over expansion in finance relative to the growth of the real sector of the economy. Most of these studies suggest a threshold effect in the finance - growth nexus and any further expansion of the former becomes a drag on economic growth. For example, Cecchetti and Kharroubi (2013) examined the negative link between the rate of growth of the financial sector relative to real sector growth. The authors found that increase in growth of financial sector reduces overall economic productivity. Similarly, Law and Singh (2014) while trying to assess the threshold level of finance and growth using sample consisting of 87 developed and developing countries, found that financial development is beneficial to economic growth only up to a certain threshold level and, beyond this any further improvement in the financial sector tends to harm economic growth. As financialization implies deregulation, the growing size and profitability of the financial sector relative to the real sector of the economy, it means that over-expansion of the financial sector poses a significant threat to the development of the real sector of the economy.

Researchers have tried to examine the relationship between finance and inequality empirically and arrived at different conclusions both in support and rejection of this relationship. Some of the researchers provide evidence of a negative relationship between financial development and inequality. For example, Stiglitz (2012) in his book on "Price of Inequality" opines that the growth of financial sector has significantly contributed to widening income inequality in US. He identified several channels through which this relationship is affected among which are: regulatory capture, rent seeking, inefficient regulation and supervision. Claessens and Perotti (2007) findings echo the findings of Stiglitz in which they emphasized the role of regulatory capture in worsening inequality. In the context of emerging economies, Law and Tan (2009) while examining the role of stock market development on income inequality in Malaysia for the period of 1980 – 2000, found that improvement in stock markets and banks' development does not reduce income inequality.

OIC countries have in recent times aggressively increased their financial sector activities and, as a result, have earned huge profits through the financial channel rather than the real sector. Similarly, it is a well-documented fact that in developed countries the banking sector has been able to significantly increase its profit through extension of credits to households and businesses without much value creation in the overall economy (OECD 2015). The same applies to the developing and emerging economies where most of the OIC countries are domiciled. Two reasons could explain the increased profits realized in OIC countries. Firstly, the increased profit to the bankers was due to aggressive lending practices by the bankers that targeted certain economic agents (mostly households and businesses). This has fuelled debt-driven consumption. Secondly, the profits realized by the banks (through charging interest on loans) were used to pay exorbitant salaries most especially to the top executives and high-ranking officials; this has further worsened the gap between the employees. However, the findings from this study suggest that, in OIC countries, financial sector growth does not affect income inequality because financial sector development is still a work-in-progress and its expansion is contributing to the economy. Most OIC economies are still emerging and they

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require the financial markets to support these developments by providing financial resources to the real sector of the economy to finance investments.

OIC countries are home to most Islamic finance institutions and most of the financial transactions are done in line with Shariah principles. For instance, in Indonesia, Islamic banks have financed the acquisition and/or construction of low-cost housing that is affordable for many citizens. It has been reported that, Indonesia has a deficit of 18 million houses and as a result many Islamic banks have taken it upon themselves to bridge this gap by providing the citizens with financing of affordable houses. This is mostly based on (Mudarabah) equity-based financial contracts with monthly instalments that are usually less than the normal monthly rental. This ensures that funds are freed for use to spend on other needed consumption. The application of Islamic principles could alleviate the suffering of the less affluent segment of the society in Muslim countries.

Debt, which is one of the major component of financialization as it measures the rate of growth of overall stock of debt relative to the growth of GDP. Since the recent global financial crisis, many governments have resorted to debt to cover their massive budget deficit (Reinhart et al. 2015) and OIC countries are no exception. Most countries in OIC countries have recorded a very high debt-to-GDP ratio with countries like Malaysia, Indonesia and Turkey topping the list. Even in some OIC countries where there is dearth of official data on household debt, unsecured loan such as credit cards debt and overdraft is widespread (for example in Nigeria and Saudi Arabia).This debt is not without serious consequences since it involves fixed commitments for repayment with interest. Without debt, the resources used for debt servicing would be used for developmental projects. In most cases, public debt is mostly held by a smaller segment of the wealthy creditors while interest charges are financed through taxes, including value added taxes. This is the case in most OIC countries where governments expand tax base through increased consumption tax in order to close the existing budget gap. This increases the burden on families who are already struggling to cope with stagnant real wages.

Islam has condemned interest-bearing debt on the grounds of social justice. Poor countries that take on loans pay significant amounts in servicing their debts, preventing the resources to be used in improving the lives of the domestic residents. In countries like Indonesia and Nigeria, which have persistent budget deficit, shortfalls are financed through borrowing. Indonesia paid $54.2 billion on debt service payment between 1998 and 2000, as highlighted in a report by Executive Intelligence Review (EIR 2000). As Islam preaches equity and justice in the distribution of wealth, its circulation must

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not concentrate only in the hands of the few (Qur'an 59:7). Therefore, debt is a serious drag to economic development as well as an increased burden to the ordinary citizens.

As debt became an all-encompassing part and parcel of modern life, it completely shaped the entire global economy. This is a common feature in the developed world and has become true for developing countries. Therefore, as a policy recommendation, this study suggests the adoption of a risk-sharing financial system which is naturally stabilizing and possesses numerous advantages to individuals and to the economy. The system encourages social integration through equity-participative financing as the risk is shared by all parties to the contract promoting more innovations and new projects in real sector of the economy. This results in increased employment and income through increased production of good and services leading to reduced inequality that exist between labour and capital owners as well as reducing the massive unemployment rate found in most of the Muslim world.