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# GLOBALIZATION & ISLAMIC FINANCE

CONVERGENCE, PROSPECTS, & CHALLENGES

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# Globalization and Islamic Finance

*Convergence, Prospects,  
and Challenges*

HOSSEIN ASKARI,  
ZAMIR IGBAL, AND  
ABBAS MIRAKHOR



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# Preface

**T**he global financial turmoil that started in 2007 and picked up steam in 2008 has again emphasized the fragility of a debt-based financial system. Debt financing during times of turbulence is akin to relying on “hot money.” Equity financing, by comparison, is more permanent and assumes risk. Moreover, with the rapid innovation in debt instruments, transparency has been replaced by opacity. As a result of unknown and opaque risks and failed financial regulation of debt instruments and debt financing, debt may be losing much of its attraction to investors, at least for the foreseeable future.

The last two decades of the 20th century witnessed a number of global bouts with financial instability and debt crises with devastating consequences for a large segment of humanity, thus raising consciousness regarding the vulnerability and fragility of financial systems that are based, at their core, on fixed-price debt contracts. While numerous international banks have seen their reputation tarnished by the sub-prime crisis, Islamic banks have been largely unscathed. They did not, and given their premise indeed *could not*, park their assets in mortgage-backed assets. This success has spiked interest in Islamic, equity-based finance, not only in Islamic countries but also in countries that support the conventional system, by both Muslims and non-Muslims. Given the state of the global financial markets in 2009, the growing interest in Islamic finance outside of Islamic countries, especially in large Western financial markets such as London, could provide the all-important boost to the internationalization of Islamic finance and promote its growth. In turn, the growing internationalization of Islamic finance will afford equity-based finance added impetus in the West. In other words, conventional finance and Islamic finance could begin to reinforce one another.

In this book, we address an overarching question regarding the future of financial globalization, and of Islamic finance: Will conventional finance, at the heart of the current financial globalization, and Islamic finance converge? There is evidence that financial globalization has not been as helpful as expected, given the potential of its benefits for growth of investment, employment, and income, as well for reducing income inequality and poverty. In our view, the success of financial globalization will depend on the spread and degree of risk sharing around the world. The greater the momentum, the deeper the markets, and the wider the spectrum of risk-sharing

instruments, the greater will be the shared ownership and participation in finance. Faster, deeper, wider financial development has a symbiotic relationship with globalization, as the feedback process between the two strengthens both. Evidence suggests that, thus far, the degree of risk sharing achieved by globalization is insignificant.

While Islamic finance has experienced phenomenal success in the last two to three decades, it still has a long way to go to achieve its objective of maximizing risk sharing. In the following chapters, we argue that the institutional structures within which Islamic finance is required to operate to promote good state and corporate governance, trust, protection of rights, and contract enforcement. In the case of Islamic finance, the progress achieved to date is a negligible fraction of the potential. The reasons are identical to those offered in financial globalization. Financial, legal, and institutional developments, and the greater pace of instrumentalization of basic modes of transactions permitted, would accelerate the progress of Islamic finance. As it would appear that Islamic finance and financial globalization share a *common objective* of achieving maximum risk sharing, it is not too unrealistic to expect convergence as we continue down this path.

We also believe that legal and institutional developments, as well as further advances in information technology, will reduce informational problems and lead to growing trust, which is essential for risk sharing. The result will be the dominance of equity in financial structures and relationships. The breakdown of trust as a result of repeated wars and catastrophes as well as financial innovations, particularly the securitization of government debt in the late Middle Ages, created the right milieu for the dominance of debt and debt finance which has lasted to the present day. We believe that conflicts and wars are the factors that most seriously threaten the future of globalization and financial globalization. How the world handles these threats may be the single most important factor determining the course of financial globalization and the possible convergence of Islamic and conventional finance.

For Islamic finance to sustain long-term growth, Muslim countries must liberalize their economies, embrace efficient institutions, and adopt consistent macroeconomic policies. They need to grow on a sustained basis and more rapidly, while also addressing the all-important issues of social and economic justice. Their sustained economic growth would be the most important impetus for a thriving Islamic financial sector; in turn, a thriving Islamic financial sector may be the best inducement for non-Islamic countries to embrace Islamic finance and equity-based assets more generally. In a globalizing world, the development of both Islamic finance and conventional finance can be expected to reinforce one another. We believe that Islamic countries are beginning to show signs that they are on the path to

faster economic growth and financial market development, and they are turning increasingly to Islamic finance and risk-sharing instruments. Affluent Muslim communities in the West are doing the same.

This book addresses the overarching question: How likely is it that conventional and Islamic finance will converge as they both go through the globalization process? The answer would be “quite likely,” if global finance relied more extensively on equity or equity-like flows, on the one hand, and invented/innovated a wider spectrum of risk-sharing instruments, on the other. A similar process of innovations in Islamic finance, coupled with financial and institutional reforms, would invigorate the growth and development of Islamic finance and enable an asymptotic convergence of the two.



# Contents

<b>Preface</b>	<b>vii</b>
<b>CHAPTER 1</b>	
<b>A Brief History of Globalization and Islamic Finance</b>	<b>1</b>
1.1 A Brief History of Globalization	2
1.2 How Complete Is Globalization?	7
1.3 A Brief Introduction to Islamic Finance	11
1.4 Islamic Finance and Globalization: Convergence or Divergence?	26
<b>CHAPTER 2</b>	
<b>The Consequences of Globalization: Convergence or Divergence with Islam?</b>	<b>29</b>
2.1 Theoretical Consequences of Globalization: Growth, Income Distribution, Poverty Alleviation, and Regulation	29
2.2 Some Empirical Consequences of Globalization	35
2.3 Financial Globalization	41
2.4 Basic Islamic Economic and Financial Doctrines and Globalization	47
2.5 Convergence or Divergence?	53
<b>CHAPTER 3</b>	
<b>Islamic Finance, Conventional Finance, and Globalization</b>	<b>59</b>
3.1 The Development of Islamic Finance	59
3.2 The Development of Conventional Finance	68
3.3 Islamic and Conventional Finance: The Impact of Globalization	70
3.4 Financial Stability and the Emerging Relationship between Islamic and Conventional Finance	75

**CHAPTER 4**

<b>Recent Developments in Conventional Finance, Financial Globalization, and Islamic Finance</b>	<b>79</b>
4.1 Introduction	79
4.2 The Role of Financial Systems and the Stability Characteristics of the Conventional Financial System	80
4.3 A Different Explanation for the Financial Crisis of 2007	94
4.4 Islamic Financial System and Lessons from the Recent Crisis	111
4.5 Summary	119

**CHAPTER 5**

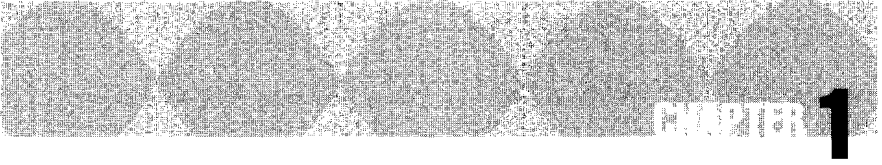
<b>Empirical Trends in Conventional and Islamic Financial Globalization</b>	<b>121</b>
5.1 Trends in Conventional Financial Globalization	121
5.2 Growth in Islamic Finance	137
5.3 Convergence or Divergence?	147

**CHAPTER 6**

<b>Key Considerations in Developing an Islamic Financial System</b>	<b>149</b>
6.1 Lessons from the Conventional Financial System	149
6.2 Gaps in the Islamic Financial System and its Practice	157
6.3 Policy Recommendations	163
6.4 Concluding Remarks	171

**CHAPTER 7**

<b>Conclusions and the Future of Islamic Finance</b>	<b>173</b>
7.1 The Future of Globalization	173
7.2 The Evolution of Financial Globalization	177
7.3 The Expansion of Risk Sharing	179
7.4 The Likelihood of Convergence	180
<b>References</b>	<b>187</b>
<b>Index</b>	<b>211</b>



# A Brief History of Globalization and Islamic Finance

**G**lobalization is a process that enhances the flow of goods, services, capital, people, technology, and ideas across national borders. It is a phenomenon whereby numerous countries combine and increasingly appear as one country; complete globalization is akin to the unification of states that today make up the United States of America. The process of globalization proceeds more rapidly when barriers between countries that affect the movement of goods, services, capital, technology, and labor are reduced, and is enhanced by reduced information and transportation costs. It is a multifaceted and multidimensional process of growing interconnectedness among the nations and peoples of the world. Its main dimensions are: (i) economic and financial, (ii) cultural, and (iii) socio-political. Its economic and financial dimensions include growing trade flows across countries, flows of capital and investment, flows of technology, and labor flows (both skilled and unskilled), accompanied by standardization of processes, regulations, and institutions, all facilitated by the free flow of information and ideas. Its cultural implications are the amalgamation of cultures, adverse impact on languages (diminution of their use) that are used by a few and are not important to business and commerce, and diminution of distinct cultural identity. Its socio-political tendencies are convergence of ideas, political and economic institutions, and norms. It is a process that affects every dimension of life and existence. The reverse of globalization may be termed de-globalization. Globalization and de-globalization are ongoing processes, and at any point in time one dominates the other; as such, the process is continuous, whether the world is becoming more, or less, global.

While the impact of globalization on conventional finance has been studied and recognized, its impact on Islamic finance, a relative newcomer, has not been addressed. Islamic finance is a system of finance that prohibits debt-based financing; thus, it prohibits interest, and the financing of activities that are not permitted in Islam, such as gambling and the manufacturing

and distribution of spirits and wines. Islamic finance is based on risk sharing, trust, transparency, and the upholding of Islamic values. It has developed and grown side by side with conventional finance over the last 40 or so years.

How will globalization affect both conventional and Islamic finance? Will they continue to flourish as two distinct financial systems, or converge over time, or will one absorb the other? How will conventional and Islamic finance affect globalization? What does their history and the history of globalization reveal about their future?

## **1.1 A Brief History of Globalization**

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Globalization is not a recent phenomenon but has a long history, as indicated by its definition as a continuous process. When the process began, nobody knows. As Findlay and Lundahl (2002, pp. 1–2) note:

*Even the most cursory inspection of the rapidly accumulating literature on the subject indicates that there appears to be about as many answers to the question as there are authors who have posed it.*

Findlay and Lundahl (2002, p. 2), however, do assert that:

*It is more than sufficient to note that if we go back eight centuries what was up to that point the strongest wave of or effort at globalization hitherto in history emanated from the Mongols. They were the main agents of the process, that is, they “pushed” globalization as it were.*

The Mongolian event of the 13th century was in some sense the earliest truly global event and, as Findlay and Lundahl note, the Mongolian Empire still has the distinction of being the largest continuous empire in recorded history. As a result of the Mongolian push, trade routes were opened from England to China. Muslims, in turn, created sea trade along the ports of the Indian Ocean and the Persian Gulf. Trade, perforce, resulted in the movement of people, and even of diseases (such as the Black Death). The rapid expansion of the Chinese economy and the power of the Mongols in China were the forces that integrated the world economy.

Beginning in the 18th century, trade started to be dominated by British, French, and Dutch overseas companies, all chartered by the state. These conditions continued until structural changes occurred in the world economy in the late 18th and early 19th centuries—railroads and steamships, and the advent of the Industrial Revolution. At the same time, the American

Revolution and independence movements elsewhere meant that nation states wrested control of their resources from foreign domination, while simultaneously European countries used their military power to expand the commercial interests of their nationally chartered companies. The British, the French, and the Dutch extended their economic imperialism into Asia and Africa, while the United States started to reach into Latin America, with military might and economic expansion going hand-in-hand. At times, global integration has been fueled by economic forces, sometimes by military conquest, and sometimes by both economic and military forces. Yet, the process of globalization has not always been unidirectional; that is, toward ever-higher levels of global integration. It has proceeded in fits and starts, with globalization and de-globalization going hand-in-hand.

The most recent periods of this continuing process of globalization, whether boom or bust, are:

1. The globalization boom of 1820–1914
2. The globalization bust, or de-globalization, of 1914–45
3. The globalization boom of 1945–?

Again, as may be inferred from the titles of the above three periods, globalization is not unidirectional as witnessed over the last two centuries. Before the onset of the hostilities that led to World War I, trade, capital, and labor flows across national borders had been increasing steadily. World War I, nationalism, and the Great Depression (accompanied by protectionism as countries attempted to protect their domestic markets) reversed the process. It was not until after World War II that there was the will to reverse the process and reduce barriers. Even then, only trade barriers were reduced, followed much later by a reduction in barriers limiting financial flows, with labor flows across most borders still highly restricted even today.

The first of these globalization phases, as in earlier periods, was imposed by military power, underpinned and supported by industrial might. England forced its way into China and conquered all of India. France colonized North Africa. A number of European powers carved up Africa. The United States enhanced its domination over South America. During the first globalization boom, the lowering of barriers and the dramatic reduction in transportation costs (steamship, rail, canals) enhanced trade and mass migration of labor, with significant convergence in commodity prices and real incomes (Lindert and Williamson, 2001). This process was widespread—across Asia, Europe, and the Americas.

In the case of labor flows, labor migration was prevalent in the 19th century, as the motivation (real wage differential and social networks) was significant with little government impediment. For example, the labor force

in Argentina and in the United States increased by 86 percent and 24 percent, respectively; while Ireland's labor force was diminished by 45 percent, and, as to be expected, with varied impacts on wage rates and economic growth (Lindert and Williamson, 2001, p. 14). International monetary reform, as embodied in the convertible currencies of the gold standard (and the silver standard), was adopted by the vast majority of countries in 1870. At the same time, given the high rates of return on foreign investment, cross-border capital flows increased significantly to levels not seen again until the last decade of the 20th century (Lindert and Williamson, 2001, p. 13). The lowering of barriers and the convertible currencies helped increase international trade/gross domestic product (GDP) from 10 percent to over 20 percent between 1870 and 1914, and cross-border capital flows/GDP from 7 percent to nearly 20 percent (Mishkin, 2005, p. 1). But capital did not flow from capital-abundant to capital-scarce countries, as would be predicted by theory (Lindert and Williamson, 2001, p. 17). Instead, capital inflows and GDP per capita were positively correlated. Thus, capital flows were not a force for convergence, indicating that the so-called Lucas paradox was a fact of life even in the 19th century. (Economic theory predicts that capital should flow from where it is plentiful to where it is scarce—that is, from developed to developing countries—but in fact the most significant flows are between developed countries; thus the paradox.) Lindert and Williamson (2001, pp. 17–18) have summarized the effect on income inequality during this period:

*Within rich, land-abundant New World countries, more trade and more immigration augmented inequality. Within poor, primary-product-exporting Third World countries, they did the same. Within poor, land-scarce, participating Old World countries, more trade and more emigration reduced inequality. As for income gaps between countries, migration had an equalizing effect, one that was only partly offset by the fact that capital flowed to rich New World countries . . . Overall, prewar [World War I] globalization looked like a force equalizing average incomes between participating countries, but with mixed effects on inequality within participating countries.*

The second era, the period of de-globalization of the inter-war years, was marked by political upheavals (such as the Bolshevik Revolution in Russia and the rise of fascism in Western Europe), rising nationalism, and policies erecting barriers and disincentives to the flow of goods, labor, and capital across countries. In North America in the face of growing domestic income inequality prior to World War I, and later during the Great Depression (high unemployment and negative economic growth), the government

adopted policies to reduce imports and to stop the inflow of emigrants. These policies were counterproductive and, in turn, affirmatively anti-global, as they slowed the flow of goods, labor, and capital across national borders. Other countries followed suit to protect their own markets in a futile bid to preserve employment and economic prosperity. Trade, labor migration, and capital flows across countries slowed dramatically. This slowdown was accompanied by acceleration in the rising inequality between countries (Lindert and Williamson, 2001, p. 19). By the end of World War II, the world economy was at a standstill, with almost no trade or capital flows across borders and little emigration. The paramount lesson from this de-globalization period is clear: if globalization marginalizes a big segment of the population of a country, especially one that is organized and influential, then the globalization process will be threatened. This simple lesson is even more valid today, when instantaneous communications around the globe are possible. The forces of anti-globalization and nationalism rise when interests are threatened. While, on the one hand, labor, and trade and capital flows affect wage rates and rates of return to capital, on the other hand, those that are affected do not directly see the impact of trade and capital flows on real wages. While the effect of trade and capital flows on wage rates is somewhat invisible, affected workers can see plainly the emigrants who have taken their jobs or reduced their real wages. As a result, in times of falling wages or rising unemployment, labor flows may be more sensitive to populist attacks than trade.

The ongoing third period, the post-World War II globalization boom, was motivated and has been driven by the shortsighted policies and the economic trauma that marked the inter-war years. The world attempted to undo the damage of those years by adopting institutions and policies that would promote cross-border flows. At the international level, the United Nations (UN), the International Monetary Fund (IMF), the World Bank, the General Agreement on Tariffs and Trade (the GATT), and more were established to promote economic reform and lower barriers to trade and capital flows. The Bretton Woods Agreement was adopted to avoid disruptive exchange rate changes and to provide short-term financing for countries facing balance of payments difficulties in order to avoid the damaging global economic contractions that had occurred in the 1930s, especially in the aftermath of Austria's inability to secure short-term financing. However, this post-World War II reversal in policies was adopted only slowly. Countries were still reluctant to dismantle trade barriers quickly, as attested to by the fact that they could not agree on setting up a World Trade Organization (WTO). A number of countries, most prominently the United States, were reluctant to compromise on important issues, especially when they felt that their national sovereignty was threatened. The best they could do was to set

up a system with little enforcement, or teeth, that was subject to periodic painful negotiations to reduce tariffs on goods alone—the GATT. Numerous trade rounds under the GATT reduced barriers to the movement of goods across national borders. The process, though not always smooth, is continuing under the more recently established WTO, with coverage extending to services and including capital flows, and with enforcement powers.

This latest period of globalization differs in many important ways from the earlier one that ended prior to World War I (Lindert and Williamson, 2001, p. 20). Labor migration has been less significant than in the earlier period. The impressive gain in the cross-border movement of goods, services, and capital has not been matched by cross-border labor flows. Even capital exports have been less significant than in the earlier period of globalization; for example, the capital exports to GDP ratio in the United States during 1989–96 was 1.2, while it was 4.6 in Britain during 1890–1913 (Lindert and Williamson, 2001, p. 20). While various measures of capital flows, especially foreign direct investment (FDI), may still be below their pre-World War I levels, the trade to GDP ratio is higher today, supported by lower trade barriers and lower transportation and communication costs. The reason for these differences between the two periods has been largely attributed to changes in US policy (Lindert and Williamson, 2001, p. 20):

*These differences are tied to policy changes in one dominant country, the United States, which has switched from [being] a protectionist welcoming immigrants to a free trader restricting immigration. Another difference . . . the postwar world started out much more unequal than the world of 1820 or 1870, and international income gaps, not income gaps within countries, now dominate the global inequality of living standards.*

During this recent phase, the process of globalization has been especially rapid since 1973: the ratio of world trade to GDP increased from 22 percent to 42 percent in 2000 (Estevadeordal and Taylor, 2002) and the share of capital inflows to GDP increased from about 3 percent in 1990 to about 14 percent in 2005 (IMF, 2007a).

But, as in an earlier period, globalization is being blamed for a number of emerging economic, social, and environmental ills: disparity in income across countries, income inequality within countries, labor standards (with countries maintaining low standards to attract foreign investors), labor conditions (with multinational firms attracted to low labor cost countries no matter what the conditions), poverty, climate degradation, and the global financial meltdown of 2007–09. While the effects of globalization on income inequality across countries and within countries are being hotly debated (see Chapter 2), the rising inequality within the United States and the United Kingdom

in the last two decades is readily confirmed by adverse changes in Gini coefficients and shares of income accruing to differing percentiles. The result is more nuanced for other OECD countries (Lindert and Williamson, 2001, p. 31). But to what degree are these effects due to globalization? While labor and environmental conditions may have suffered, to what extent are these a failure of government policy or directly attributable to globalization? It is evident that globalization, as with most other things in life, may have both positive and negative effects. The issue may be whether governments can ameliorate the negative effects through policies to enhance the benefits and become net beneficiaries of the process of globalization. In assessing the impact of globalization and devising policies to maximize its net benefits, it must be remembered that globalization is not the most direct instrument for affecting incomes, growth, income distribution, poverty, or more. Governments have an arsenal of policy instruments at their disposal for addressing such issues much more directly.

## **1.2 How Complete Is Globalization?**

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Today, the broad global economic picture is one of diversity, or more accurately, one of gross inequality (see Table 1.1). While the US per capita income was around US\$38,000 in 2007, the world average was in the neighborhood of US\$6,000 and that of low-income countries was a mere US\$334. For the countries that comprise the Islamic Conference (OIC), representing nearly 25 percent of the global population, per capita income was only US\$1,501, a figure that was a fraction of the Organization for Economic Co-operation and Development (OECD) average, only a quarter of the global average, and would fit neatly in the “lower middle income” category as defined by the World Bank.

Globalization is today far from “complete.” For instance, consider a country whose share of global GDP is 25 percent and whose trade/GDP is 15 percent. Is globalization “complete” for such a country? The answer is an emphatic “no.” If a country’s share of global GDP is 25 percent (roughly similar to the United States today), for “complete” trade globalization, its trade/GDP should be 75 percent, not 15 percent (again, the rough US share today). By this measure, globalization in the area of trade has a long way to go (compare Tables 1.1 and 1.2). The United States represented 29.3 percent of global GDP but had an export/GDP of only 10.5 percent (which should be in the order of 70 percent for complete globalization) and the OIC represented 5.5 percent of global GDP but had an export/GDP of 30.6 percent (which should have been in the order of 95 percent for complete globalization).

In the case of financial globalization, such a ready measure is not available, as a country’s share of global finance is difficult to define. One could

**TABLE 1.1** Economic Indicators

	GDP (US\$ billion)		Per Capita (US\$)		Population (million)	
	2000	2007	2000	2007	2000	2007
OIC <sup>1</sup>	1,567	2,194	1,228	1,501	1,276	1,461
United States	9,765	11,564	34,600	38,338	282	302
Euro area	6,245	7,069	20,400	22,182	306	319
High income	25,934	30,398	25,793	28,777	1,005	1,056
High income: OECD	24,730	28,781	26,767	29,805	924	966
High income: non-OECD	1,207	1,656	14,793	18,257	82	91
Middle income	5,647	8,506	1,425	1,997	3,962	4,260
Upper middle income	2,903	3,833	3,715	4,659	781	823
Lower middle income	2,745	4,671	863	1,359	3,181	3,437
Middle East & North Africa	431	585	1,561	1,868	276	313
Low income	370	538	334	415	1,108	1,296
World	31,949	39,436	5,258	5,964	6,076	6,612

*Source:* World Development Indicators, The World Bank.

<sup>1</sup>Limited or no data for some countries, including Afghanistan, Iraq, Qatar, and Somalia.

**TABLE 1.2** Trade and Capital Flows

	Exports (% of GDP)		Imports (% of GDP)		FDI Inflows (%)		FDI Outflows (%)	
	2000	2007	2000	2007	2000	2007	2000	2007
OIC <sup>1</sup>	38.53	30.63	31.44	36.74	0.56	2.94	0.18	0.60
United States	11.2	10.5	15.1	16.3	3.3	1.4	1.6	1.8
Euro area	36.6	39.8	35.9	38.5	10.2	3.8	3.5	5.5
High income	23.9	25.7	24.4	26.4	5.3	2.7	3.5	3.5
High income: OECD	22.1	22.5	22.8	23.9	5.2	2.6	3.4	3.4
High income: non-OECD	69.8	112.4	62.2	99.5	0.0	8.7	0.0	0.0
Middle income	27.4	31.0	25.9	31.2	2.8	3.1	0.4	1.2
Upper middle income	27.8	30.5	26.2	29.5	3.4	3.3	0.6	1.7
Lower middle income	27.1	36.8	25.6	33.9	2.1	2.9	0.1	0.7
Middle East & North Africa	26.8	33.9	25.6	39.1	1.3	4.2	0.1	0.0
Low income	28.0	30.5	30.0	36.1	1.7	3.1	0.0	0.0
World	24.6	27.0	24.7	27.2	4.9	2.8	3.0	3.0

*Source:* World Development Indicators, The World Bank.

<sup>1</sup>Limited or no data for some countries, including Afghanistan, Iraq, Qatar, and Somalia.

venture a proposition that, with globalization, the domestic investment to GDP ratio should be comparable to foreign investment to GDP ratios. Taking FDI as a surrogate for foreign investment, the reported FDI ratios are not comparable to what we assume to be domestic investment to GDP ratios. At the same time, the FDI ratios are diverse across country groups and are quite low for most country groups. Globalization is clearly limited in the area of finance; flows between the rich countries dominate these flows (the Lucas paradox), indicating that flows to developing countries have a very long way to go. Moreover, if Shiller (2003) is even partially correct in foreseeing the future of financial markets and the new financial order, then the management of risk, especially cross-border diversification of risk, has barely begun.

While trade and capital flows may have a considerable way to go before being truly globalized, the “tap” on labor flows has not even been opened in the current globalization phase. The severe restriction on labor flows is dramatized by the number of would-be illegal immigrants who die on the high seas or in railroad cars, and stand in long lines at the embassies of advanced countries and wait, sometimes for years, to secure legal immigrant status. Today, the legal flow of labor is largely limited to those with higher levels of education. The cross-border flow of educated labor increased in the latter half of last century, and especially following the change in immigration laws in the United States in 1990. But quotas and other restrictions still severely limit the flow of even educated and skilled labor. The flow of labor has a long way to go before “complete” labor globalization can be claimed, with similar wage rates paid for comparable labor skills all over the world.

The unimpeded flow of technology across borders also has far to go. Many countries, but especially the United States, have imposed ongoing sanctions on dozens of countries, especially in the area of advanced technology. Companies are afraid to license their most sensitive technologies until they are afforded better protection against piracy.

No country in the world comes close to meeting these targets indicated for complete globalization in terms of the flow of goods, capital, labor, and technology. If countries today feel the pressures of globalization, they have seen nothing yet compared to what lies in store should the globalization process ever be permitted to continue unabated.

Globalization has both its fans and detractors. Some argue that globalization increases economic growth and prosperity, no matter what; others believe that faster growth can come about only *if* countries are properly positioned to take advantage of it, requiring sound institutions and policies; and yet others argue that globalization is bad for everyone, no matter what policies and institutions are embraced. Some assert that globalization increases income inequality between countries, others that it has an adverse effect on income equality *within* countries. Still others argue that globalization increases global poverty. Because globalization can be so all-encompassing,