

MAS-ESS ESSAY COMPETITION 2002

The Role of the State in an Increasingly Borderless World

Second Prize-Winner, Students Category

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Summary

This paper highlights issues which states face in this era of globalisation, and explores policies that governments can take to overcome them.

In an interconnected world, states are more interdependent, with the integration of factor flows, product and financial markets in the global marketplace. This poses certain challenges: increased foreign competition hastens the destruction of inefficient industries, causing greater unemployment; the liberalisation of capital markets and the resultant volatility in global short-term capital flows potentially destabilises countries. The increased mobility of people and capital results in greater competition for both FDI and labour. Globalisation extends the influence of the new knowledge-based economy, putting emphasis on technological creation as a medium for growth. The over-concentration of trade and investment in certain regions leaves countries more vulnerable to economic contagion. Finally, globalisation creates the impetus for international cooperation to solve problems relating to the world economy.

States can respond in several ways. Domestically, labour mobility and productivity can be enhanced with a greater emphasis on human capital development. Indigenous innovation should be promoted with greater government expenditure on R&D, a rethink of current institutions and policies, and the cultivation of 'technopreneurs'. Local firms can be persuaded to diversify into untapped overseas markets for investment and export growth. There must be a cultivation of ties between the state and her growing overseas citizenry. Financial institutions should be strengthened to guard against excessive capital flows. Improvements to infrastructure and reducing business costs can foster an attractive investment climate for foreign investors. Internationally, states will require greater diplomatic

dexterity in cooperating to draw up the framework for international trade and finance, and ensure free trade.

In conclusion, globalisation is a double-edged sword, and by remaining relevant in the world economy, states can turn apparent challenges into opportunities for growth.

Introduction

We are all living in an interconnected world. The 'global village', once a concept confined to the realm of science fiction, has with technology become a reality. In such an environment, engagement with the international community is no longer an option, for it is now imperative for states to remain relevant to changing global trends. This phenomenon has become known as globalisation, and in the past few decades, it has transformed the worldwide economic landscape, with the promotion of free trade, deregulation and the privatisation of nationalised industries. Globalisation has spurred the growth of new industries in areas such as Information Technology (IT), leading to the coining of the term "Knowledge-Based Economy" to describe the future trends in economic development. But globalisation has also exacerbated existing problems within and among countries, and created new ones. For example, the divide between rich and poor nations has widened, and the income gap within most countries has also increased. Economic contagion has become a feature of the past decade, with the financial crises affecting Mexico, Brazil, Argentina and Thailand spilling over to neighbouring countries and destabilising entire regions. All this has been attributed to the force of globalisation.

In this essay, I will discuss the challenges posed by globalisation, and the various policy implications this has on government policy-making.

Defining Globalisation

Globalisation refers to the integration of factor flows, product and financial markets into the global marketplace. Nation-states have become more interdependent, politically as well as economically. This interdependence has grown

dramatically in the past few decades, affecting the ability of governments to respond to economic issues, and altering the tools available to them to do so.

Globalisation works on several levels: first, transport and communications have improved, with a corresponding fall in costs, with the growth in air transportation and the IT revolution. Second, international trade and capital flows have increased as trade barriers fall and governments reduce restrictions on the flow of capital abroad. Between 1970 and 1997, over 102 countries removed foreign exchange controls.¹ Third, giant multinational corporations (MNCs), of the likes of Sony and Glaxo Wellcome, continue to expand into overseas markets, resulting in a great deal of foreign direct investments (FDI) flowing into countries. On a global scale, FDI inflows from 1991 to 2000 actually jumped six-fold from US\$202 billion to US\$1270 billion!² Lastly, consumer tastes in various products, from soft drinks to fashion, have become more similar, as a result of the interaction of different cultures around the world.

Challenges In a Increasingly Borderless World

As a result of globalisation, physical barriers that divide countries become less significant, and people and capital are able to pass through national borders with much greater ease than in the past. The world becomes more interlinked, with factor flows, product and financial markets integrated into the global economy. The challenges posed by globalisation are listed below. They concern the fundamental structure of the economy, and must be met with by effective government policies.

¹ Sloman (2002)

² UNCTAD Online Handbook of Statistics, stats.unctad.org

i. Increased competition from other countries in international trade will accelerate the destruction of inefficient firms and industries, as they are unable to compete in the new global marketplace of many different competitors. This will destroy secure jobs for a great many employees, and cause large-scale unemployment. Long-term structural unemployment may increase with the greater rate of structure upheaval in the economy. In the meantime, the beneficiaries of globalisation will see their incomes rise dramatically. The widened income gap requires government intervention, in the form of a “helping hand”.

ii. With the liberalisation of capital markets, the growth of the financial and banking sector tends to outpace the growth of the real economy, as seen in many developing economies. However, there is often a lack of adequate safeguards to ensure good corporate governance, as well as the political resolve to enforce the rules. The premature lifting of capital controls has resulted in large short-term capital flows between nations. This may lead to instability in a country should there be a mass-migration of short-term funds out of the economy. Crises will ensue, as can be seen from the experiences of the Asian and Latin American economies in the nineties.

iii. The increased mobility of both capital and people in a global economy means countries must step up their efforts to attract and retain them, resulting in greater international competition for foreign direct investment (FDI) and skilled labour. Migration policies among countries are sifting towards barring the entry of unskilled labour while accepting highly-skilled manpower. The ability and temptation for talented individuals to migrate overseas will require states to come up with policies that prevent a brain-drain in the workforce.

iv. The IT revolution, riding on the back of globalisation, is transforming the economies of many developed and developing countries, including those in East Asia. The new economy requires countries to attain a high level of technology so as to tap the new markets that IT opens up. Countries must shift their emphasis from focusing on capital accumulation to increasing their investments in research and development (R&D), while equipping workers with the necessary skills for such an economy. With the IT age, a new engine of growth, 'technopreneurs', or technology entrepreneurs, has also risen into prominence.

v. Nation-states realise that they are no longer fully in control of their domestic market. Trade and investment linkages expose countries to economic contagion. Globalisation has created greater interdependence between countries, encouraging governments to work together, on both a regional and a global level.

Domestic Policy Implications

Globalisation and the new economic environment it creates require governments to review existing domestic policies on labour, science and technology, citizenship, banking, trade and finance. The following addresses the changes that will have to be made in these policy areas, with reference to East Asia and the Singapore economy, in greater detail.

I) Improving Labour Mobility and Productivity

Unemployment that results from structural changes in the economy is a key feature of globalisation. Structural unemployment stems from workers not having the required skills to undertake new jobs that are created by the knowledge-based economy. This is particularly so if workers are less educated, as they will be less

occupationally mobile. To tackle this, workers must be retrained to be able to cope with new technology and machinery. Training programmes and facilities can be provided, together with government incentives for workers to retrain. Retraining also serves as a useful measure to reduce wage inequity by closing the skills divide that separate the lower and higher income groups. In Singapore, where 62.1% of the workforce has secondary education and below³, this is covered by schemes such as the Skills Redevelopment Programme. The lack of job insurance in most East Asian economies tends to further persuade workers to take up new skills.

Strong trade unions can also bring about unemployment by keeping wages at artificially high levels. This discourages firms from employing more people. Moreover, wage increments that exceed productivity gains result in higher costs to the firms and reduce its competitiveness. Trade unions also hamper a country's restructuring efforts by resisting layoffs. The solution is for states to diminish the power of trade unions, either via legislation or state-sanctioned arbitration. States should make it easier for firms to hire and fire, and reduce wage rigidities in the labour market.

Governments should also view the development of human capital as a competitive strategy to attract foreign investments and boost productivity. To start with, the education system should be revamped to discourage rote learning, emphasize creativity and research, and create enterprising, visionary leaders. Education must keep pace with rapidly changing technology and teaching methodology. Indeed, the modern theory of human capital development is not

³ Annual Manpower Statistics 2002, Ministry of Manpower

simply about increasing the time one spends being educated, but increasingly, also about improving the quality of the education one receives.

Likewise, states ought to reduce their reliance on foreign unskilled workers, and step up efforts to attract highly-skilled people from abroad. States that give firms easy access to foreign unskilled labour will impede the industries' restructuring process and depress local wages, while lowering the skill profile of the workforce. This will lead to long-term inefficiency and a loss of competitiveness in these industries. Highly-skilled foreign labour, on the other hand, can share their expertise with the local workforce, leading to technology transfer. Skilled labour is often in shortage, resulting in structural bottlenecks that limit industry growth. The influx of such individuals can help to resolve such bottlenecks, raise productivity levels and increase employment opportunities for the economy as a whole. In Singapore, such 'foreign talent' are attracted via a change in immigration policy, encouraging them to settle here permanently, and low income taxes. Construction firms are also discouraged from employing unskilled foreign labour as they incur higher levy payments.

Developing and increasing the pool of human capital will thus enable states to increase their productivity and international competitiveness, while reducing unemployment. In addition, a more mobile labour market can contribute to the diffusion of know-how through the workforce.

II) Encouraging R&D and Technopreneurship

Technology is the driving force behind the new knowledge-based economy created by globalisation. However, many countries, in particular Singapore, tend to be over-dependent on technological transfer from foreign MNCs based in the

country. Hence, there is a dearth of indigenous research and development (R&D), which requires states to implement a national science and technology policy to promote it.

Such a policy would, first and foremost, necessitate that the state increases government investment in R&D activities to levels comparable with advanced industrialised countries. Industrialised countries like the US and Japan spend 2.84 and 3.06 percent of their GDP on R&D, while Singapore and Taiwan pale in comparison, with a R&D/GDP ratio of 1.84 and 1.98 percent respectively⁴.

Further, states will have to focus on basic research, and not just applied research to gain a more lasting competitive advantage in the market. Emphasis will have to be placed on creating break-through technologies and anticipating future problems of industries. Producing many copycat technopreneurial start-ups based on existing technology often points to a lack of technological depth, and these may be easily overtaken by foreign competition. On the other hand, places like Silicon Valley and Israel, with their strong focus on basic research, are able to produce cutting-edge technology consistently that are more resistant to foreign competition.

Encouraging local technopreneurship should be central to a government's science and technology policy, in order to develop a solid local technological base to break into the large and sophisticated markets of industrialised countries, such as the US and the EU. In this respect, the presence of venture capital funds is imperative in financing technopreneurial start-ups, since other financial institutions will be unwilling to fund such high-risk activities. Countries should also reduce the amount of red tape regarding the operation of such start-ups. In Singapore, a US\$1

⁴ National R&D Survey of Singapore, 1999, NSTB (2000)

billion technopreneurship fund has been set up, which together with new bankruptcy laws and taxation rules, seeks to attract more local technopreneurs to set up shop. In addition, up-and-coming economies such as China are vying for a share of the global manufacturing pie. To maintain competitiveness, states must produce more value-added goods and services, and shift away from low-end manufacturing. This shift up the production ladder can only be accomplished by investing in technology.

Ultimately, institutional changes must occur for an indigenous science and technology policy to be effective. There must be a realignment of current institutions and policies to fit with the new science and technology. The education system must focus more on the elements of risk-taking and creativity to nurture more entrepreneurs, for example. Institutional innovations that have succeeded in other countries, such as the R&D consortium model in Taiwan and the “Incubator Management Company” model in Israel, should also be adapted to facilitate institutional change.

III) Diversification of Export Markets and Overseas Investments

Globalisation has spurred the regionalisation process, whereby neighbouring countries come together to increase trade and firms expand into overseas markets. However, this may lead to an over-concentration of investments and export earnings in a particular region, and any instability there will have serious repercussions on the well-being of the state economy. The Asian financial crisis in 1997 showed how countries in the region, heavily dependent on each other for trade and investment, were all badly affected by the economic contagion that emanated from the financial collapse of the Thai economy. This underscores the need for countries in the region

to look beyond their immediate surroundings in search of new export and investment markets.

To decrease the state's dependence on her neighbours, governments can persuade local firms to 'internationalise' and take full advantage of the new markets opened up by globalisation, by pushing beyond national and regional boundaries to tap the bigger world market for export and investment. The benefits to firms, after all, are numerous, they can achieve higher efficiency (via lower labour costs etc.) and greater economies of scale, exploit superior foreign technology and ultimately lower product costs and get higher returns on their investment. To this end, the state can offer financial incentives to firms that invest in non-traditional markets like Latin America and Eastern Europe, or even shoulder some of the risk of venturing overseas, as the EDB is doing in Singapore by offering to share some 70% of the risks in overseas ventures involving firms.

IV) Maintaining Links with a Global Citizenry

With greater international flow of labour and the migration of people between countries, more and more people will be living outside their countries of birth. Many developing nations, such as India and the Philippines, now depend on their diaspora for remittances to support their economy. States will have to adapt to this development by adopting a more flexible attitude towards citizenship, and cultivating closer ties with their overseas citizenry.

States may allow for a more accommodating policy of dual citizenship. This can sustain the bonds between a country and her diaspora, and enables migrants to feel equally attached to both their country of origin and their adopted home. Steps may also be taken so that nationals working overseas maintain links with their

mother country. Embassies and consulates can facilitate the setting up of clubs to foster greater interaction among the expatriate community and their relatives back home. The building of schools overseas allows expatriate children to be educated in line with the domestic education system. Singapore has an organisation known as the Singapore International Foundation, which through its vast network of publications and activities, enable overseas Singaporeans to remain informed about domestic developments. Furthermore, states should provide opportunities for overseas citizens to return home and work, so as to prevent a brain-drain of talent overseas. Specialists and professionals, in particular, bring back from abroad precious experiences and skills when they return to take up jobs in their home country.

V) Strengthening of Financial Institution

The financial crises around the world in the last decade exposed a serious flaw in many of the crisis-hit countries – a weak banking and financial sector. While most advanced Asian economies already have strong banking regulations, there is still a need to ensure banks are more transparent in their operations, improve their accounting standards and maintain sufficient solvency. There should also be regulations in place to reduce short-term borrowing by local banks in order to prevent future liquidity crises.

Due to the volatile nature of foreign short-term capital, states may prefer to put in place certain capital controls to stabilise capital flows in and out of a country and curb speculation. In this respect, Singapore has a long-standing policy of disallowing bank lending in local currency to foreigners. Also, to avoid the over-reliance on overseas funds to finance local investments, countries can develop long-term bond

markets. In this way, domestic savings can be channelled into local instead of overseas investments, and the risks of sudden short-term capital outflows destabilising the economy.

VI) Maintaining an Attractive and Stable Investment Climate

The rise of China as an economic power on the world stage with its entry into the WTO, together with the increased mobility of capital, signals a more competitive global environment for foreign direct investment (FDI). States have to meet this challenge by investing in infrastructure and enacting measures that reduce the costs of doing business, so as to make themselves more attractive for foreign investors. Corporate tax cuts are a popular means to lure foreign companies to set up here, but the government will undoubtedly suffer a reduction in its revenue. Revenue collection thus has to come from other sources, such as indirect taxes on consumers and greater cost reclamation from the provision of public services. This can, however, make income more inequitable, and creates a dilemma for most governments that choose to reduce the amount of direct taxation on companies by levying an indirect tax on households.

The growth spurt in many countries brought about by globalisation has also led to increases in the price of non-traded goods and services. Left unchecked, the rise in prices can result in exports losing price competitiveness, and lead to the formation of speculative 'bubbles' in certain assets, such as property, encouraging capital inflows. The inevitable bursting of such bubbles, when foreign investors realise their folly and pull out, can be disastrous. Hence, the solution is for states to increase productivity in the non-traded goods and services sector in order to control the rise in prices, and monitor the growth of any speculative 'bubbles'.

External Policy Implications

The growing interdependence of world economies and the increased volatility arising from globalisation tends to encourage states to seek greater cooperation with each other in dealing with international economic issues. Such cooperation can exist in the form of coordination of economic policies among nations to stabilise the international business cycle and prevent worldwide recessions, and the strengthening of international lending agencies to circumvent the financial crises that have arisen in the past decade. This section deals with how countries can cooperate with each other to reduce the perils of globalisation.

Greater trade among nations creates the impetus for states to come together to create rules, such as those pertaining to intellectual property rights protection, and resolve disputes in international trade. This was the reason behind the creation of the WTO. Countries should also join hands in promoting free trade for mutual benefit, either by signing free-trade agreements or by becoming members of regional trade bodies such as APEC, ASEAN and NAFTA. In this way, more markets can be freed up for foreign competition, allowing all parties involved to gain. The removal of the remaining barriers to free trade is especially important to developing agricultural economies in bridging the rich-poor country divide, as their produce is still prevented from entering the European and American markets by extensive protectionistic policies that shield EU and US farmers from competition.

World financial bodies like the IMF and the World Bank enable states to work out a principal framework of regulations that can be internationally implemented to smooth out problems with international finance. Global issues that require inter-governmental cooperation include: the need for an international lender of last resort

to solve sovereign liquidity problems; and reducing the volatility of international capital flows, perhaps via the imposition of an international Tobin tax⁵ on foreign exchange transactions.

However, seeking international cooperation is not so straightforward in practice when states have conflicting goals and policy objectives. Then, they are likely to see each other as competitors, rather than collaborators. The challenge is to seek out common ground, and this will require greater diplomatic dexterity, especially with the growing complexity of issues and the increasing number of parties involved. In this respect, problems may be easier solved with domestic policies than with international relations, since with the latter it is harder to reach mutual consensus. Furthermore, states that become members of regional and world groupings may have to give up some sovereignty and the ability to make certain individual economic decisions, since such decisions must be taken in consultation with other countries, as can be noted from the process of economic integration within the European Union.

Concluding Remarks

This essay has examined the ways in which governments can better plug into the world economy, by considering how the various issues that come with globalisation, including greater competition, the importance of technology and human capital, increased mobility of factor flows, and the strength of financial institutions can affect states. The different policies, both domestic and international, which states can employ has also been discussed.

⁵ Tobin tax – A tax on foreign exchange transactions originally proposed by Yale Professor and Nobel laureate James Tobin, to control capital flows and provide a useful source of revenue.

In the final analysis, globalisation is an unstoppable force that is transforming patterns of trade and investment between countries. It generates pressure for governments to pursue sound and effective financial policies. Globalisation indeed poses new challenges to governments of individual states, but is a double-edged sword, and by adopting measures to cope with the new realities brought about by the phenomenon, states can turn these challenges into opportunities for growth instead.

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