Volume Title: Macroeconomic Linkage: Savings, Exchange Rates, and Capital Flows, NBER-EASE Volume 3

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Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38669-4

Volume URL: http://www.nber.org/books/ito_94-1

Conference Date: June 17-19, 1992

Publication Date: January 1994

Chapter Title: Introduction to "Macroeconomic Linkage: Savings, Exchange Rates, and Capital Flows, NBER-EASE Volume 3"

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Chapter URL: http://www.nber.org/chapters/c8525

Chapter pages in book: (p. 1 - 5)

Introduction

Takatoshi Ito and Anne O. Krueger

This volume contains the papers presented at the third annual East Asia Seminar, held in Sapporo from June 17 to June 19, 1992. The theme of the conference was the macroeconomic linkages between the global economy and the East Asian and North American countries.

The world economy has become so highly integrated that almost anything that happens in one country affects all others. But the key macroeconomic variables that strongly affect the global environment include savings and investment behavior, exchange rates, monetary and fiscal policies (including interest rate determination) and the resulting capital flows, and of course, trade. In the 1980s, the macroeconomic experience of the East Asian countries was important for their own economies and also strongly affected North America and the rest of the world. Real exchange rate swings of the yen, the won, the NT dollar, and the U.S. dollar were pronounced. The large U.S. current account deficit was offset, at least in part, by large Japanese capital flows to the United States. In the 1980s, Japan, and later Korea and Taiwan, recorded large current account surpluses which triggered U.S. political pressure on these countries.

These events led to a closer examination of the key macroeconomic linkages between countries. The papers in this volume examine some important aspects of these relationships, and increase our understanding of the extent of interdependence, and the ways in which economic events in one country are transmitted to, and affected by, events in the rest of the world.

The papers presented here are organized around four themes: the overall determinants of growth and trading relations, monetary policies in relation to

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capital controls and capital account, the impact of exchange rate behavior on industrial structure, and, finally, the potential for greater regional integration.

Overall growth has been an important phenomenon in itself, but in addition, the rapidly growing East Asian countries have also had increasingly strong trade and payments positions. The factors accounting for these phenomena are investigated in four papers. The first of these, by John Helliwell, contains an overview and analysis of the growth performances of the Asian countries. Noting that East Asia has been spectacularly successful in achieving growth, Helliwell attempts through regression analysis to understand the factors that led to that high growth. Frequently given explanations that he tests include the openness of the trade regime, measured by the frequency of nontariff barriers to imports, the appropriateness of the real exchange rate as reflected by the black market exchange premium, and the relative importance of import duty receipts. He also uses an index of the degree of democracy and measures of the extent of human capital. Human capital fails to explain the rapid growth of the East Asian countries or the lower growth of South Asian countries. Helliwell's regression results find more explanatory power in the measures of openness of the economies. In the discussion that follows, other factors contributing to the differentials in growth rates are discussed.

The Japanese current account balance has been particularly important for the international economy, providing sizable net savings to the rest of the world, especially the United States. In the second paper, Takatoshi Ito investigates the determinants of the Japanese current account, analyzing the extent to which underlying factors such as the real exchange rate, and more transitory factors such as the Gulf War contributions, have affected its size. Ito concludes that the underlying Japanese surplus was shrinking until 1991, but that even taking into account transitory factors, it began increasing again in that year. Ito points to real exchange rate behavior as a key factor in that reversal and uses estimated export and import functions to simulate the responses to the real exchange rate in the absence of a transitory component. His simulations indicate that, given the real exchange rate, the current account balance in Japan would have begun increasing in 1991 in the absence of transitory factors.

The next paper, by Bon Ho Koo and Won-Am Park, analyzes the large Korean current account surpluses which emerged from 1986 to 1988 and their disappearance starting in 1989. They point to the low oil price, the appreciation of the yen, and lower worldwide interest rates as factors accounting for the emergence of the large surplus. After 1989, won appreciation and domestic demand expansion policies led to a reversal of these surpluses. Just as Ito found for Japan, Koo and Park find that an upturn in the world economy is likely to result in a greater increase in exports of goods and services than in imports and thus in an improvement in Korea's current account balance.

The final paper focussing on determinants of the capital account examines the case of Taiwan. Gee San analyzed the effects on Taiwan's trade flows of fluctuations in the NT dollar exchange rate, estimating export and import functions for Taiwan. He found that the rapid appreciation of the NT dollar against the U.S. dollar in the late 1980s had a major effect on the Taiwanese export structure.

The second group of papers focuses on capital controls and monetary policies. Sung Hee Jwa's analysis investigates the history of Korean capital controls since the early 1980s and contrasts them with the situation in Japan, Taiwan, and Indonesia. Capital controls in Korea were heavily influenced by the current account deficits in the early 1980s, as the authorities were concerned with mounting foreign debt at the time of the world debt crisis. After the Korean current account shifted to surplus in 1986, capital inflows began, which in turn resulted in won appreciation (encouraged by the U.S. government). The net result was greatly increased capital mobility both into and out of Korea by the late 1980s, with consequences for the functioning of domestic monetary policies.

In the next paper, Rachel McCulloch analyzes the contribution of Japanese and other East Asian current accounts to global savings, asking how net demands for international investment and savings will balance in the 1990s. She concludes that there may be a smaller contribution to world savings from Japan than in the past and notes that this could result in smaller flows of foreign direct investment into other countries in the East Asian region. However, McCulloch's data and analysis suggest that the overall magnitude of any shift is not likely to be great and that changes in world real interest rates could accommodate most of any change.

The third paper focusing on capital flows and monetary controls examines Taiwanese price and monetary behavior. Chung-Shu Wu and Jin-Lung Lin begin by noting that Taiwan has had a high rate of monetary growth combined with remarkable price stability. They note, however, that the NT dollar appreciated during the period, so that there was a change in relative prices; simultaneously, output was growing rapidly. As a result of exchange rate appreciation, prices of Taiwanese goods became more expensive, but that was offset in the price index by the falling (in NT dollars) price of traded goods. Meanwhile, rapid growth of output also absorbed some of the monetary growth. In a quantity-of-money framework, the increased quantity of goods and the falling price of foreign goods enabled the overall price level to remain stable. In the ensuing discussion, Wu and Lin note that the decline in oil prices was a factor contributing to the remarkable growth and stability experienced not only by Taiwan but also by other East Asian countries.

The last two papers in this section focus on the theoretical properties of exchange rates, real money balances, and foreign borrowing as possible explanatory variables important in explaining East Asian performance in the 1980s. Shin-ichi Fukuda investigates the dynamic properties of exchange rates and real money balances in a small open economy in which the representative agent has real money balances in his utility function. He shows that, under a floating exchange rate regime, there are circumstances in which there can be endogenous cycles in the exchange rate. One interesting question raised in the discussion is whether such exchange rate behavior could be distinguished from that under a random walk.

One of the key features of the 1980s in the international economic arena was the fluctuation in real exchange rates. The third group of papers examines the effects of these fluctuations on industrial structures of countries in the region. Pochih Chen, Chi Shive, and Cheng Chung Chu first examine the change in the commodity composition of Taiwan's exports as the NT dollar appreciated toward the end of the 1980s. As real appreciation took place, Taiwan's exports of labor-intensive commodities diminished as capital-intensive industries' exports expanded. By the end of the decade, Taiwan's comparative advantage appeared to lie in products with a medium degree of both labor and capital intensity, compared to the United States and Japan. Human capital appears to have emerged as a major factor affecting Taiwan's comparative advantage.

Bih Jane Liu also examines the effects of NT dollar appreciation, focusing on more short-run factors. She investigates why the pass-through effects of NT dollar appreciation to the U.S. dollar–denominated price of Taiwanese exports was so small. Her first step is to develop a model in which oligopolistic firms produce and export two differentiated products with a cost externality. Liu then shows that the larger the cost externality, the larger the degree of pass through. However, if the externality becomes sufficiently large, the degree of pass through can even turn negative. Empirical tests of this model for Taiwan show that the pass-through ratio (i.e., the elasticity of the export price with respect to the exchange rate) is less than one in most industries and even negative in a few.

In the final paper in the third group, Kazumi Asako and Yoshiyasu Ono investigate the short-run dynamics of inventory adjustment and exports to analyze the extent to which the export-drive hypothesis may be valid. The export-drive hypothesis is that an extra effort is made to push exports when unplanned inventories rise due to sluggish domestic demand. It is assumed that the firm sells in both domestic and foreign markets. When there is inventory accumulation due to an autonomous decrease in domestic demand, it is optimal to increase exports because of production and inventory smoothing. Thereafter, inventories and exports gradually decline to a new steady state. Under these circumstances, one would observe a positive correlation between inventory holdings and exports. For the importing country, if a quota reduces its trade deficit by the same amount as a tariff, the quota improves welfare more by shifting the inventory cost of adjustment to the exporting country.

The last set of papers examines questions that are important regarding regional linkages. All focus on the extent of future regional integration.

Jeffrey Frankel and Shang-Jin Wei analyze the extent to which there are regional linkages that might permit the yen to become a regional currency. There are three ways in which this might happen. First, the yen could become increasingly important over time as a currency with respect to which other

Asian countries set their exchange rate policies. Second, there might be a regional trading bloc centered on Japan. Third, the fact that Japan is a low-inflation country and other countries stabilize their exchange rates by pegging to its yen might increase the role of intraregional trade.

Frankel and Wei regress the various Asian exchange rates on each other and the U.S. dollar and the European currencies. They find that the yen is far from replacing the U.S. dollar in the region. They also find that the share of intraregional trade in East Asia does not show any upward trend in the 1980s. Turning to bilateral trade flows, they examine these flows with respect to the volatility of exchange rates and find that more volatility does seem to reduce trade flows. All of these findings suggest that there is little evidence of the formation of a yen bloc and that strong trade and other economic ties continue to link East Asian economies to the United States.

Hiroo Taguchi then proceeds to examine the possibility of a yen bloc in a parallel fashion. The three roles that the yen could play would be: (1) a currency used by nonresidents, (2) a currency anchoring a trade bloc of Asian countries, and (3) a nominal anchor for other Asian countries' exchange rates. Taguchi, like Frankel and Wei, finds little basis for the hypothesis that the yen will become a regional currency or that a trade bloc might form. He does conclude, however, that there may be some value to other Asian countries in using the yen increasingly as a nominal anchor for their own currencies.

The final paper is by Junichi Goto and Koichi Hamada, and it considers the necessary preconditions for Asian regional integration. They find more similarities among Asian countries and more interdependence than was present in Europe in the 1950s before the start of the Common Market there. Using principal component analysis, they also find that real disturbances in East Asia are more closely synchronized than in other regions and that the degree of capital and labor mobility is quite high. However, noting the strong trading ties with the United States, they conclude that there is little or no possibility for an Asian free trade area that excludes the United States.

Hence, although Goto and Hamada find more basis for increasing regional integration than do Frankel and Wei or Taguchi, none considers that East Asian regional linkages could come at the expense of global exchange and trade relations. Linkages across the Pacific, and with the global economy, are too valuable and too important for Asian countries to be able to contemplate any regional linkages that would sacrifice integration with the rest of the world.