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Introduction

Takatoshi Ito and Anne O. Krueger

One of the striking trends in the international economy over the past several decades has been the increased mobility and volume of capital flows. It is estimated that the *daily* volume of international financial transactions now exceeds the annual value of global GNP.

Increased financial mobility has been both a cause and a result of increasing financial integration of the global economy. With greater integration, domestic financial markets are increasingly affected by world events. Dialogue among the major countries' governments increasingly focuses on the appropriateness of each others' policy stances with regard to monetary, interest rate, and exchange rate policy.

Capital flows motivated by interest rate differentials used to be limited to industrial countries. However, in the 1990s, some developing countries, now called "emerging markets," became a popular destination for direct and portfolio investment from industrial countries. For example, net capital flows from industrial countries to developing countries are estimated to have increased from less than $15 billion in 1990 to more than $100 billion in 1993. There are at least three reasons for this rapid change. First, those developing countries with high growth and current account surpluses obviously became attractive investment opportunities because of their high potential capital gain and likely currency appreciation. Second, industrial countries suffered recessions, and their interest rates came down substantially. Third, large institutional investors in the United States started to diversify into international investment opportunities.

Simultaneously, regulation of domestic financial markets, which in earlier

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years appeared both feasible and consistent with efficient economic performance, has been greatly affected. Decisions regarding changes in interest rates in any large national capital have immediate effects on financial conditions in all other countries; efforts to control interest rates in such circumstances can lead to large financial flows between countries. That, in turn, can limit the efficacy of monetary policy instruments aimed at domestic macroeconomic balances.

In part because earlier types of regulation no longer effectively achieve their intended result because of increased financial integration, and in part because those regulations that appeared to serve their purpose earlier now appear to impinge on the efficient functioning of financial markets, countries around the world have been engaged in widespread financial deregulation.

Nowhere has this trend been more pronounced than in the countries of East Asia. Japan has assumed its role as a major creditor nation only within the past two decades. Moreover, with its large current account surpluses, the challenges of managing of its own domestic macroeconomic aggregates have changed greatly. Simultaneously, the East Asian newly industrialized economies (NIEs), which began their rapid development in an era when capital markets were less integrated, have faced the dual task of liberalizing their markets in response to their own growth as well as to the changing international economy.

Deregulation itself has proved challenging, both because of increased interdependence and because deregulation inevitably affects the functioning of the macroeconomy in ways that are not well understood. In a number of cases, deregulation has affected the behavior of exchange rates, interest rates, and capital flows in unanticipated ways.

As deregulation spreads to emerging markets, these countries start to enjoy the benefits and pay the costs of being linked to the world capital market. As the economic prospects of a country become brighter, capital suddenly flows into the country and may provide scarce resources for more investment and growth. However, the capital flows may appreciate the currency so that the competitiveness of export industries suffers, or may cause expansions of domestic credit that result in inflation. Integration in the world capital market makes the policy options very different from before.

The fifth NBER–East Asia Seminar on Economics focused on financial deregulation and integration in the East Asian region, with a view to understanding how deregulation is affecting those markets and to improving knowledge of the ways in which financial integration is affecting responses to various policies in the countries of the region.

The papers presented at the conference, which are collected in this volume, cover a wide variety of aspects of this topic—deregulation per se, exchange rate behavior under alternative regimes, responses of capital flows to deregulation and integration, behavior of individual types of capital flows (such as direct foreign investment), and so on. As a group, the papers demonstrate both the widespread nature of deregulation and the challenges that deregulation presents, especially because of the mobility of capital between countries.

The first two chapters in this volume focus on the interrelationship between domestic financial changes and the international economy more generally. As already mentioned, deregulation and integration have been global phenomena, affecting countries in Europe, North America, South America, as well as Asia. Some of the phenomena are general, and lessons from other parts of the world are applicable to Asia as well.

In chapter 1, McKinnon and Pill consider a problem associated with a number of policy reform efforts, that is, what they term "excessive" capital inflows. When policy reforms are credible, people may want immediately to increase their consumption in anticipation of higher future real incomes, and the result is a sharp deterioration in the savings-investment balance, financed by a large increase in capital inflows (which would not have happened in earlier years when there was little capital mobility). McKinnon and Pill believe that it is financial market failures that do not brake these large inflows, so that there has been financing even for very risky projects and a sharp deterioration in banks' balance sheets. This situation is intensified when (implicit or explicit) deposit insurance for banks creates a moral hazard problem. The authors believe that the authorities should not deregulate controls over capital flows or financial institutions at too early a stage of the policy reform process because of these problems and should seek ways to reduce capital inflows to appropriate levels.

Chapters 2, 3, and 4 examine various aspects of the determinants of capital flows between countries. In chapter 2, Eaton and Tamura examine the roles of the United States and Japan in trading with and investing in various countries in the Asia-Pacific region. They use a gravity model to ascertain the determinants of U.S. and Japanese flows, using variables such as population, factor endowments, per capita incomes, and distance. They find that Japan and the United States relate to other countries in the region in similar ways, although Japan's lack of natural resources affects trading patterns and the U.S. current account deficit has limited the U.S. role as a provider of capital.

Wei, in chapter 3, examines the origins and the effects of foreign direct investment (FDI) in China. A first finding is that FDI comes overwhelmingly from overseas Chinese, and not from the countries that have been suppliers of foreign capital to other economies in the region. He then proceeds to relate differences in growth rates of Chinese cities to the magnitudes of capital inflows and finds that they contribute significantly to cross-city differences in growth rates and also the rate of growth of Chinese exports.

Kohsaka's analysis in chapter 4 focuses on the capital flow links among the countries of Asia. He finds that there has been considerably greater financial integration among countries in the region in recent years. Moreover, both foreign direct and portfolio investment into Southeast Asian countries grew rapidly during the 1980s, but the major source of increase was from the NIEs of

East Asia, rather than from Japan, although Japan remained a large supplier of capital to the region. The turnabout in the role of the NIEs from capital recipients to capital suppliers is the major structural change that took place with respect to capital flows in Asia in the 1980s.

Chapters 5 and 6 focus on particular aspects of Japanese financial markets. Fukuda investigates the determinants of the invoice currencies of Japanese exports and imports. He finds that there is a very low fraction of Japanese exports where invoices are denominated in yen, even in transactions in East Asia, contrasted with practices in Europe and the United States. Using sectoral data on invoice currencies, Fukuda relates this practice to Japanese exporters' strategy of pricing-to-market, absorbing exchange rate risk so that they do not lose market share when the yen increases in value. On the import side, the low fraction of yen-invoiced goods is attributable to the high fraction of primary commodities, such as oil, in Japan's imports and the practice of pricing those commodities in U.S. dollars.

Horiuchi analyzes some aspects of Japanese financial liberalization in his paper. He examines liberalization of the corporate bond market, which reduced the reliance of Japanese firms on bank financing. Horiuchi shows that the manner in which liberalization was carried out created a new distortion in the financial system. The distortion was the restriction of the right to issue convertible bonds to large well-established firms, thus preventing some firms that could have employed additional capital with a high rate of return from obtaining it, and permitting managers of the large established firms to enjoy additional perquisites.

Lin, Lee, and Huang, in chapter 7, use the experiences of both Korea and Taiwan to investigate the macroeconomic policy implications of export-led growth. The paper contends that monetary, fiscal, and exchange rate policies were influenced and in fact disciplined by the pursuit of an export-led growth strategy. Sound fiscal policy, however, is identified as an important way to give more freedom to other policy instruments within the overall goal of keeping export industries competitive. Although the central banks in Taiwan and South Korea were legally "independent," they accommodated the need for development funds; thus inflation rates were relatively high during the years of high economic growth.

In chapter 8, Yang and Shea begin by noting that Taiwan's rate of inflation was very low—3 percent, on average—during the 1980s despite average annual growth of the money supply of around 20 percent. They develop and test a quarterly model, incorporating money demand for stock and real estate trading and the level of imports (itself a function of the appreciation of the NT dollar) and conclude that these two phenomena explain the relative stability of Taiwanese prices.

Chapters 9 and 10 analyze the financial liberalization of the Korean economy. In chapter 9, Park provides a survey of financial policies and liberalization in Korea since the early 1980s. He shows that, to date, the impact of financial deregulation in Korea has been primarily on nonbank financial institutions. He examines the savings-investment balance and interest parity conditions in an effort to ascertain the degree to which Korean financial markets have become integrated with the rest of the world and concludes that there is still significant capital immobility. Park's analysis suggests that the barrier to increased financial efficiency in Korea is now the banking system itself, and that its deregulation could result in significant increases in efficiency.

In chapter 10, Nam examines the bank-business relationship in Korea. He argues that while the "principal transactions" bank system in Korea helped carry out credit controls and avoided excessive concentration of banks, it also hampered the autonomous development of bank-business cooperation, of the type that occurs in Japan's main bank system. Nam predicts that with the liberalization of Korean bank credits, the largest corporations will have bargaining power with the banks, while smaller established companies will be restricted to an exclusive relationship with one bank. While Korean industrial groups are quite similar in structure to their Japanese counterparts, the relationship between a group and a bank in Korea is very different from that in Japan, affecting the outcome of liberalization processes.

Chapters 11, 12, and 13 examine aspects of financial liberalization in Singapore and its neighboring countries. In chapter 11, Woo and Hirayama examined the possible reasons for the freedom in interest rate policy, namely, deviations of the domestic interest rate from the U.S. dollar interest rate. Three episodes of government interventions in the foreign exchange markets in Indonesia, Malaysia, and Singapore at various times are cited for creating enough uncertainties to cause risk premia, a wedge between the domestic and foreign interest rates. In chapter 12, Tse and Tan use the interest parity condition between Singapore and the Eurodollar market to test the effect of deregulation. They find that deregulation was associated with a marked reduction in the divergence of interest rates from uncovered interest parity, which is consistent with the view that the degree of capital mobility increased as deregulation progressed.

In the final chapter, Ngiam surveys the process of deregulation of the Singapore financial market, including the evolution of SIMEX, the Asian Dollar Market, the Singapore stock market, the Asian Dollar Bank Market, and Forex. He then evaluates the prospects for Singapore's emergence as a financial center for the region. While financial deregulation has made Singapore more competitive as a financial center, the fact that Hong Kong and Japan are also deregulating means that competition to become the financial center of the region is increasing.

This volume provides a good picture of the overall status of financial markets in Japan, China, Korea, Taiwan, and Singapore. All countries in the region—as in much of the rest of the world—are in the process of financial deregulation, and none has completed the transition. Both the analysis and the empirical results provide evidence of the complexity of the process of financial deregulation and the challenges it poses for policymakers everywhere.