FRBSF WEEKLY LETTER

November 11, 1988

# Monetary Policy in the Pacific Basin

The importance of the Asia-Pacific Basin in the world economy has grown enormously over the past three decades. Over this period, average output growth in this region has consistently surpassed that of any other region in the world. Moreover, in recent years, the rapid growth and transformation of the financial systems of the Asia-Pacific nations have made this region an exciting arena for observing financial reform and deregulation. Since the mid-1970s, almost all countries in the region have undertaken steps to reform and liberalize their domestic financial systems and to remove restrictions on international capital flows.

Financial market development, liberalization, and reform have posed new challenges to the central banks of Pacific Basin nations. Policymakers have responded by changing their conduct of monetary policy. To analyze these developments, compare experiences, and draw policy implications, the Federal Reserve Bank of San Francisco sponsored a major conference last Fall drawing together central bank officials from the Pacific Basin region, academics, and other scholars. The papers prepared for that conference were recently published in a volume entitled *Monetary Policy in Pacific Basin Countries.* This *Letter* provides an overview of the implications of the financial market transformations for the conduct of monetary policy in the region based on the findings of the studies presented at the conference.

**Restrictive environment**

During the 1970s, the degree of financial market development and sophistication varied widely among countries in the Pacific Basin. Correspondingly, the degree of financial market restrictiveness and the conduct of monetary policy varied as well. Some nations, notably the United States, Hong Kong, and Singapore, had relatively free and well-developed financial markets. At the other end of the spectrum were countries with heavily regulated financial systems, such as Indonesia, Korea, Taiwan, and China.

In spite of this diversity, nearly all the financial systems in the Pacific Basin were subject to regulatory and legal restrictions on financial activity. In most countries, these restrictions included interest rate regulations, credit allocation controls, explicit and implicit taxes on financial institutions, and/or international capital controls. Such measures were designed to affect private saving-investment flows through their influence on the flow of credit and to finance government expenditures by extracting seigniorage through money creation and regulation of the financial sector.

Policymakers sought to control the flow of loanable funds from savers to investors because they wanted to ensure the flow of funds to certain sectors of the economy and, they felt, the normal financial intermediation process could not guarantee the socially optimal allocation of credit. Consequently, interest rate regulations on both deposit and loan rates were used as instruments of monetary policy. Likewise, credit controls were imposed to encourage lending to priority sectors, including the government. These controls ranged from quantitative restrictions on lending by various types of financial institutions to measures that encouraged lending to certain sectors through central bank rediscounting of credits to those sectors at subsidized rates. Finally, controls on both inflows and outflows of international capital prevented financial institutions from evading domestic financial controls by undertaking transactions in external markets.

**Winds of change**

Since the mid-1970s, a variety of forces have been at work to force changes in the financial markets of countries in the Pacific Basin. Inflationary monetary policies in the mid-1970s, coupled with regulated deposit rates that yielded negative real returns, drove private savings from regulated banks. Then, in the late 1970s and early 1980s, monetary authorities' attempts to bring inflation under control put further pressure on interest rates and accelerated this process of financial disintermediation. In time, such disintermediation led to the growth of nonbank financial institutions and markets outside the regulated sector, thereby reducing the effectiveness of the existing apparatus of monetary control.

At the same time, policymakers in most Pacific Basin countries came to recognize that financial restrictions hindered economic growth. Ceilings on interest rates, by depressing real interest yields in high inflation environments, worked to reduce incentives to accumulate domestic financial assets. Domestic investment was consequently dampened. Credit controls also allocated credit inefficiently by emphasizing financing for government deficits and capital-intensive projects of large firms to the detriment of smaller firms, which were denied access to organized financial markets.

External macroeconomic developments and competitive pressures from abroad also made it more difficult to maintain tightly regulated financial systems and created another motivation for reform in many countries. In particular, rising foreign interest rates stimulated the demands of domestic investors for higher returns on financial assets and intensified pressures for reductions in exchange and capital controls.

Given the shortcomings of the existing financial regulatory framework in most Pacific Basin countries, policymakers sought to lessen the government's role in directing resource allocation and to permit market forces to reduce distortions and inefficiencies. As a result, almost all countries have relaxed interest rate controls on bank deposits, lowered bank reserve requirements and liquidity ratios, eliminated rules concerning the allocation of credit, stopped providing special credit at preferential rates, and reduced exchange controls. In many instances the authorities have also sought to encourage the development of new financial instruments with open-market determined interest rates.

**Monetary policy**

The changes in the structure of financial markets have changed the conduct of monetary policy in all these countries in the last 15 years. While the extent and specifics of these changes have varied across countries, their direction generally has been toward market-oriented conduct of monetary policy.

In the countries with already highly developed financial markets, the conduct of monetary policy has changed relatively little. For example, in the United States, the Federal Reserve has continued to rely on the market mechanism in conducting monetary policy, using open-market operations to affect the level of bank reserves. The deregulation of deposit rates since the late 1970s has induced only modest changes in the way policy is conducted. Likewise, the only significant policy shift in Hong Kong occurred in 1983, when it changed from floating to fixed exchange rates. In Singapore, the shift from direct controls to a market-oriented monetary policy occurred early, and was largely accomplished by 1975.

The greatest shifts in monetary policy regimes have occurred among the countries in the Pacific Basin where financial systems have undergone relatively greater transformation. For example, in the early 1980s Australia and New Zealand abolished interest rate controls, floated their exchange rates, and completely discarded the use of administrative directives for the conduct of monetary policy. Both central banks shifted to extensive use of open-market operations for adjusting the level of bank reserves. The development of monetary markets operating outside the regulated banking sector has facilitated the central banks' open-market operations.

Indonesia, in a dramatic leap, cast off all its direct controls in both the domestic financial markets and the foreign exchange market and floated its exchange rate. In addition, it has assiduously nurtured the growth of domestic money markets by issuing large volumes of central bank certificates and establishing institutions to ensure the liquidity of the new instruments in secondary markets. As a result, domestic money markets have developed sufficiently for the central bank to engage in open-market operations in domestic securities in order to supplement operations in the foreign exchange market.

The changes in Japan's monetary policy regime have been more modest. The pressing need to finance large government deficits, which grew fivefold in the late 1970s, forced Japan to dismantle interest rate controls and to permit new financial instruments and markets to arise, although the pace has been gradual. It has also gradually removed capital controls. Floating exchange rates have enabled the Bank of Japan to retain some indirect control of domestic interest rates.

Korea and Taiwan have tried to develop their financial systems by creating money markets outside the banking sector, and in the process have also partially liberalized their exchange controls while simultaneously attempting to peg their exchange rates. Monetary policy in both countries is still conducted primarily through direct controls on state-owned banks, although interest rates are now adjusted more frequently in response to changes in market conditions.

Thailand also has not changed its way of conducting monetary policy very much. The central bank's attempt to stabilize both the exchange rate and domestic interest rates in the face of widely fluctuating world interest rates has exacerbated money instability, however. More recent policy changes suggest a move toward greater exchange rate stability and more domestic interest rate flexibility.

Finally, monetary policy in China is changing dramatically, as the nation moves away from a rigid, planned economy to one that is more market oriented. In the process of reforming the economy, a central bank has emerged, and state-owned banks have been allowed to engage in deposit taking and business financing under the central bank's close administrative controls. A rudimentary interbank money market has emerged, but there is no significant open money market yet. Although the country is still in an early stage of developing a market-oriented banking system, monetary policy in China is assuming an important role in macroeconomic stabilization for the first time.

**Conclusions**

The changes in the conduct of monetary policy in Asia-Pacific nations over the last 15 years have been both a response to the rapidly changing economic and market environment of the 1970s and 1980s and a reflection of fundamental revisions in the regulatory thinking of national authorities. While the extent of change has varied from country to country, the way monetary policy is conducted in the region now is fundamentally different from the way it was conducted in the mid-1970s.

Monetary authorities now have greater independence from fiscal authorities because financial liberalization has spurred the development of money and capital markets, thereby enabling central banks to pursue open market operations more actively. As a result, central banks are relying less on discount policy, reserve requirements, and direct control of credit.

Moreover, the development and deepening of domestic financial markets, together with the growth of international financial markets have increased the mobility of international capital, and as a consequence, have tied domestic interest rates more closely to world interest rates. In this new environment, individual countries have had to revise exchange rate regimes and policies that rely on insulation from world interest rate fluctuations.

The new financial environment has posed challenges to central bankers, and they have responded with major changes in the way they conduct monetary policy. It is too early to evaluate the relative success of each nation's particular policies, but it is clear that the departure from the past has led to greater economic efficiency in these nations.

**Reuven Glick**
**Senior Economist**

**Michael Hutchison**
**Assistant Professor**
**University of California, Santa Cruz**

Interested readers may obtain copies of the book, *Monetary Policy in Pacific Basin Countries,* edited by Hang-Sheng Cheng, by ordering directly from the publisher:

Kluwer Academic Publishers
P.O. Box 358, Accord Station
Hingham, MA 02018-9990

Research Department

Federal Reserve
Bank of
San Francisco

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington