INTEREST PARITY CONDITIONS AS INDICATORS OF FINANCIAL INTEGRATION IN EAST ASIA

Market participants and policymakers have a growing interest in the development of East Asian financial markets, and to the extent to which these markets are open and influenced by world markets. This paper examines the information contained in interest parity conditions about the international integration of a wide range of economies in East Asia. Legal restrictions on the capital account and tests of covered, uncovered and real interest parity are presented in some detail. Using standard regressions, cointegration analysis and error decompositions, it is argued that uncovered interest parity tests reveal a surprisingly large amount of information about financial openness. For example, McCallum’s (1994) model of the interaction of uncovered interest parity and a monetary policy reaction function can be used to explain striking anomalies that arise between countries. Openness and the importance of foreign interest rate shocks appear to have increased in most countries, although Korea remains an important exception. Four policy implications are discussed in the conclusion.

Introduction

The integration of markets implies, on the face of it, an increase in transactions and a tendency for prices in those markets to converge. Hence, the international integration of financial markets implies an increase in capital flows and a greater tendency for the common-currency prices and returns on traded financial assets in different countries to converge. The convergence of returns is typically measured by closed, covered, uncovered and real interest parity over a set of traded assets, including money market instruments, long-term securities and equities. This paper examines covered, uncovered and real interest parity for money market instruments in Australia, Hong Kong, Indonesia, Japan, Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand to evaluate the financial integration of these economies with the world market.

First of all, the current state of the laws concerning the capital account of selected countries in East Asia is reviewed, and then some issues concerning data are briefly discussed. In the fourth section, new evidence is presented and assessed on covered interest parity relative to US traded assets for Australia, Hong Kong, Japan, Malaysia, Singapore, Taiwan and Thailand. US assets are the best for comparison since their markets are deep, liberalised and