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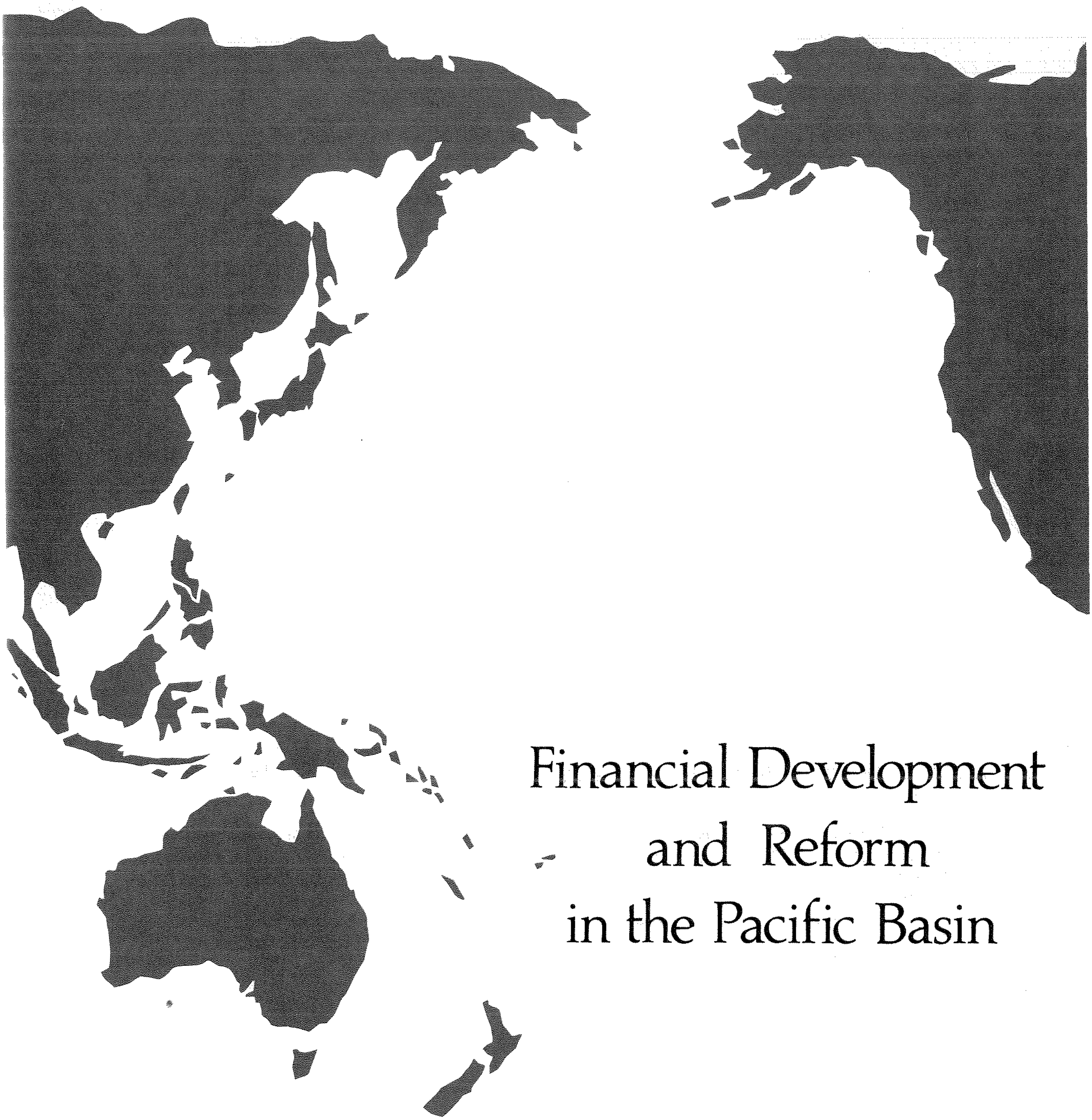

Financial Development and Reform in the Pacific Basin

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Recent financial reform legislation in the United States, including the Depository Institutions Deregulation Act of 1980 and the Depository Institutions Act of 1982, represents a response to the rapid changes that have taken place in the U.S. financial markets over the last dozen years. These changes were compelled by high inflation, technological advances in communications and information systems, and the need to float unprecedented amounts of government securities. Similar developments have occurred in other countries. The three articles in this *Review* offer a Pacific Basin perspective on the interaction between market forces and government regulation of financial markets.

In the first two articles, the authors show how market forces have led the authorities in Australia, New Zealand, and Japan to institute sweeping changes in the manner in which they regulate their respective national financial markets. The last article shows how the Asian Dollar Market has arisen in response to market demand and supportive government policies.

In the first article, Hang-Sheng Cheng studies how Australia and New Zealand, "with essentially similar financial structures and regulatory frameworks," nevertheless "reacted in markedly different ways" to the inflationary pressures on their economies.

Cheng starts his study with a brief overview of the two countries' financial systems. He notes that the authorities in both New Zealand and Australia considered regulatory policies integral instruments of monetary policy because they lacked an open money market that could offer alternative methods of money control. Regulatory policies were used to pursue macroeconomic policy objectives and therefore are key to an understanding of financial reform in the two countries. In particular, Cheng cites interest-rate controls, asset and liability restrictions on financial institutions, and direct credit controls as regulatory devices designed to contain inflation and to ensure an adequate supply of low-cost credit to favored sectors.

These regulatory controls, however, failed to contain inflation and, according to Cheng, resulted in market distortions as evidenced by several notable efforts to bypass them. An unregulated commercial bills market, for example, grew rapidly in New Zealand before the government limited its activities in 1976. A "curb market" for mortgage financing boomed in New Zealand in the 1970s, as did the unregulated financial sector in Australia. Finally, in both countries, asset and liability controls on financial institutions were needed to ensure a captive market for government securities whose rates were usually kept below competitive-market levels.

New Zealand's government tried several strategies for dealing with inflation in the 1970s. Beginning in 1972 with a tightening of regulatory controls that failed to achieve their goal, New Zealand next tried lifting most regulations. Its authorities deregulated interest rates in 1976 and, more significantly, lifted all controls on non-bank financial institutions. In the wake of these changes, the government found itself facing competition for funds in the market. In response, it started a government securities market in August of 1978. Cheng states that this action meant that, for the first time, New Zealand could influence its money supply through open market operations. The deregulation of financial institutions' portfolios followed, as an interbank call-money market was allowed to develop and institutions were authorized to issue negotiable certificates of deposit, to invest in local securities, and to operate in the commercial bills market.

By mid-1980, New Zealand's financial system was largely deregulated. In 1981, however, the authorities reversed the course of reform. In reaction to continued high interest rates, they reimposed interest rate controls.

Australia has pursued a more consistent course of reform. Because it had been more flexible in its use of regulatory policy (by raising interest-rate ceilings and permitting the regulated trading banks to diversify their activities through subsidiaries in the unregulated markets), it had escaped strong pressures for financial reform until 1979. At that time, however, the accumulated market distortions and drawbacks of the regulatory approach led Australia to relax interest rate controls. In 1980, it removed ceilings on trading and savings bank deposit rates. Lending rates were not deregulated, but the ceiling on them was raised well above the prevailing market rate. In December 1981, the government-appointed Campbell Committee, assigned to make a comprehensive study of Australia's financial system, released its Final Report recommending, in Cheng's words, "a thorough overhaul of the financial system."

The momentum of reform in Australia would seem to indicate that the Campbell Committee's recommendations stand a good chance of being implemented. Cheng, however, warns that this is not a certainty. New Zealand's reversal of a decade's reforms, he concludes, shows that "the course of financial reforms is, in the short run, determined more by political will than by market forces."

In the second article, Charles Pigott describes the progress of financial reform in Japan since the early 1970s. He points out that, traditionally, Japan's financial system has been highly regulated, with the flexibility of interest rates and the variety of available financial instruments severely limited. This regulation was, he asserts, aimed primarily at influencing the cost and allocation of credit to various sectors in order to promote Japan's economic growth.

Pigott argues that the extensive liberalization of Japan's financial system over the last decade was largely a response to several worldwide economic upheavals—inflation, recession, higher oil prices, floating exchange rates—that greatly altered financial flows and, in the process, the financial requirements of various sectors of the economy. These shocks, he believes, have greatly increased Japan's "...need for a more flexible financial system in which market forces play a greater role in allocating credit than in the past." Freer markets are necessary, he asserts, to ensure an efficient allocation of credit in Japan's evolving economy and to provide the financial instruments to meet the changing needs of businesses and households.

The Japanese authorities' response was to undertake extensive reforms aimed at liberalizing interest rates and financial flows. Starting early in the 1970s, the flexibility of most regulated interest rates was increased by tying them to the central bank discount rate. More recently, money-market interest rates were completely deregulated, leaving these rates (as well as bank loan rates) largely free to vary with market forces.

Other reforms have broadened the financial instruments available to the public, and particularly to commercial banks. The creation of a commercial bills market in 1972 gave banks a secondary-reserve asset that they had lacked before. In 1979, banks were authorized to issue negotiable certificates of deposit, in part to help them absorb a growing volume of government debt. A major reform of Japan's banking law that took effect in April 1982 allowed banks to enter the government-securities business.

Even more dramatic have been Japan's moves to liberalize its financial relations with the rest of the world. Traditionally, the authorities had severely restricted international capital flows, particularly the access of foreigners to Japan's financial markets. But "...to facilitate the financing of Japan's current account imbalances and improve the efficiency of the foreign exchange markets..." this policy was virtually reversed in 1978. As a result, Japan's money markets are now closely linked with those abroad, and the principle of equal treatment of foreign banks in Japan and their Japanese competitors is now recognized.

Pigott points out, though, that the progress of reform has been somewhat uneven. Deposit interest rates and rates in the primary bond markets remain heavily regulated while the asset choices of households are nearly as limited as they were a decade ago. Still, he argues, financial reform in Japan has been both more extensive, and more at the instigation of government, than in the U.S., but *only* because Japan's financial system was originally so much more rigid and government-controlled than our own.

Pigott draws several lessons from the experiences of both the U.S. and Japan with financial reform. Financial reform, he argues, tends to develop an internal momentum, mainly because liberalization often generates pressures for further unravelling of regulations. For this reason, the process of reform is very likely to continue in both countries. Their experiences also suggest, he believes, that financial liberalization often causes fewer difficulties if it is undertaken *before* pressures for it become irresistible.

Ken Bernauer writes early in his study of the Asian Dollar Market that "(a) need for the facilities of an Asian offshore dollar center existed well before its inception in 1968," but that the development of that market "was not feasible until regulations were altered to allow banks there to compete on equal terms" with their European counterparts.

Singapore, with locational advantages over other countries in the area (its working day overlapped that of the European markets) and a lack of a natural resource base, invited the establishment of an offshore dollar center with a series of tax concessions and changes in banking regulations. In 1968, its government exempted from withholding tax the interest paid on non-residents' deposits in Singapore banks licensed to deal in foreign currencies. Later, it cut the tax on bank profits from Asian dollar offshore loans and waived or rescinded several estate and stamp duties. The Monetary Authority of Singapore also abolished the 20-percent liquidity ratio that licensed banks operating in the Asian dollar market were required to hold against deposits. In 1978, it lifted most exchange controls.

Largely as a result, the Singapore Asian dollar market grew from $30.5 million in 1968 to $85 billion at the end of 1981. Singapore's share of the combined European and Asian dollar markets increased from .35 percent in 1970 to 4.77 percent at the end of 1981. Accompanying this growth was a significant transformation in the nature of the Asian dollar market. According to Bernauer, "At the beginning it was almost exclusively an interbank market that served as an adjunct to the Euro-dollar market, but given the impetus of the 1973–1974 oil shock, it has become a mature banking center serving the rapidly growing economies of East Asia."

The development of the Asian dollar market in Singapore has brought both benefits and costs to the country. Bernauer names the loss of a degree of domestic monetary control as the chief cost and general danger to countries hosting offshore banking centers. Singapore has used a licensing procedure to separate the activities of different types of banks and a number of incentives, including different tax treatments and reserve requirements, to discourage the substitution of Asian dollar market accounts for domestic deposits. In the end, however, these methods have met with only limited success, and the authorities rely on moral suasion.

Despite these drawbacks, Bernauer believes that the benefits of hosting the Asian dollar market have, on balance, been positive for Singapore. The benefits include the increase and improvement in financial services that has helped the country's balance of payments. Moreover, the Asian dollar market has given Singapore's workforce valuable skills in the fields of banking and finance, stimulated a string of complementary activities, and made Singapore attractive to regional corporations and multinational firms.