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Measuring time-varying capital mobility in East Asia

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Abstract

This paper examines the dynamic capital mobility in East Asia's newly industrialized economies (NIEs). We propose an alternative measure of capital mobility based on an intertemporal current account model that is developed by Shitaba and Shintani [J. Int. Money Financ. 17 (1998) 741]. We present the time-varying parameter estimates to illustrate the different processes of financial liberalization in these developing countries. The results indicate that capital is much more mobile over time, corresponding to the liberalization policies. Our findings are sharply in contrast to the previous studies, which show the lower degree of capital mobility either in developed or in developing countries.

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1. Introduction

International capital mobility is a well-documented phenomenon after financial deregulation and capital account liberalization pursued in developing countries since 1980s. Increasing integration of capital markets has promoted the surge of private capitals of developed countries inflowing to developing countries. Capital inflows stimulate investment and economic growth in the recipient countries, allow intertemporal smoothing in consumption, and thus raise welfare across countries. At the same time, they also increase the vulnerability of the recipients to a sudden reversal of capital inflows. Therefore, how to investigate the evolution and magnitude of capital movements has become more and more prominent in light of the debates regarding the optimal response to capital inflows in East Asia after the recent Asian crisis.

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Several papers have focused on how to measure the degree of international capital mobility. As pointed out by Frankel (1992), Montiel (1993), and Obstfeld (1995), two major measurements have been frequently used in the existing literature. One is to compare the correlation between national saving and investment rates, and the other is to compare the returns on financial assets in different countries.

In a seminal paper, Feldstein and Horioka (1980) propose that if international capital markets are well integrated, the saving–investment correlation should be low, because investments can be financed by foreign savings. On the contrary, the correlation will be high under the low capital mobility, because domestic investments have to be financed by domestic savings in this case. Low mobility will occur when there are risks involved in investing abroad and official restrictions on capital movements.

Feldstein and Horioka (1980) and their followers find statistically significant, large positive correlations between saving and investment rates for OECD countries, both in cross-section and in time-series studies.¹ According to their arguments, these findings are strong evidences against the null hypothesis of perfect capital mobility, namely, the mobility is considered to be low.

Baxter and Crucini (1993) and Obstfeld and Rogoff (1996), among others, have listed several skeptical arguments against the validity of interpreting the correlation between saving and investment rates as a measurement of the degree of capital mobility.² Feldstein and Horioka's (1980) approach is not explicitly based on a theoretical model, because the saving–investment regressive equation cannot be directly derived from a theoretical model. Therefore, the saving–investment correlation is difficult to make an obvious economic interpretation for capital mobility. We need a theoretical model to measure the degree of capital mobility.

In addition to Feldstein and Horioka's (1980) approach, the degree of capital mobility is also examined by interest rate arbitrage, which focuses on the relationship between capital flows and interest rate differentials, because international movements will equalize the return between domestic and foreign assets of the same type, eventually.

Chinn and Frankel (1994), Marston (1995), and Obstfeld and Taylor (1998) have utilized the covered interest differential measurement and shown a higher degree of the capital mobility in developed countries. Unfortunately, forward exchange rate markets are either extremely sparse or nonexistent in most developing countries, so we cannot use the covered interest differential measurement, but have to use the uncovered interest rate arbitrage instead.

Edwards and Khan (1985) present a theoretical model that postulates the domestic market-clearing interest rate to be a weighted average of the hypothetical interest rate under the perfectly open case and the hypothetical interest rate under the financial autarky.³ The weight parameter serves as an index of capital mobility. The hypothetical interest rate under financial autarky is derived from the money market equilibrium

¹ See Dooley, Frankel, and Mathieson (1987), Bayoumi (1990), and Tesar (1991) for cross-country studies, and Frankel (1986) and Obstfeld (1986), among others, for time-series studies.

² For the detailed interpretation of SI correlation, see Obstfeld and Rogoff (1996, pp. 162–163).

³ For more detailed explanations of interest rate determination identity, see Edwards and Khan (1985) and Haque and Montiel (1990).

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