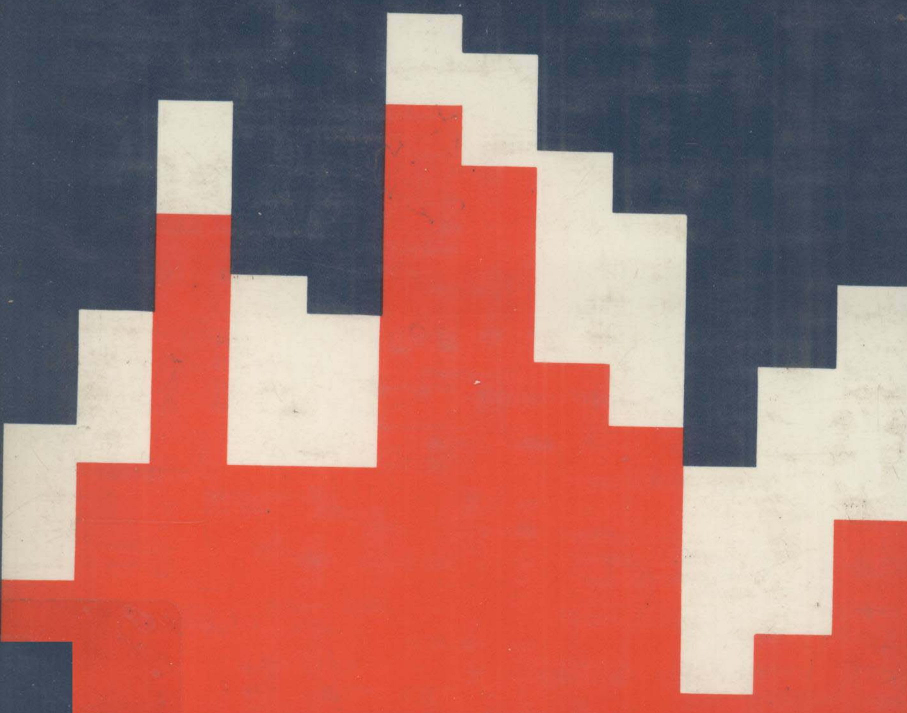
FINANCIAL STRUCTURES and MONETARY POLICIES in SOUTHEAST ASIA



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Financial Structures and Monetary Policies in Southeast Asia

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St. Martin's Press New York

St. Martin's Press, Inc., 175 Fifth Avenue, New York, NY 10010
Printed in Hong Kong
First published in the United States of America in 1982

ISBN 0–312–28973–1

Library of Congress Cataloging in Publication Data

Lee, S. Y. (Sheng-Yi)
Financial structures and monetary policies in Southeast Asia.

Bibliography: p.
Includes index.
1. Finance—Asia, Southeastern. 2. Monetary policy—Asia, Southeastern. I. Jao, Y. C.
II. Title.
HG187.A789L43 1982 336.59 81–9399
ISBN 0–312–28973–1 AACR2

Preface

This is a book about the structure of financial institutions, and the *modus operandi* of monetary policies in six countries in Southeast Asia: namely, Hong Kong, Singapore, Malaysia, Indonesia, Thailand and the Philippines. The purpose and scope of the book is fully explained in Chapter 1.

As a jointly written work, the division of labour may be briefly described as follows. S. Y. Lee is responsible for Chapters 3-9, while Y. C. Jao is responsible for Chapters 1-2. Throughout the process of writing this book, the two authors have frequently exchanged ideas and discussed their draft chapters with each other, so as to co-ordinate their analysis and presentation as closely as possible.

The book is addressed to the general public, primarily students of economics and finance, businessmen and intelligent laymen interested in the economic and financial affairs of the region. For this reason, the authors have tried to avoid an overly technical approach to the subject. However, it is hoped that specialists in money and finance, as well as experts on Southeast Asian studies, will find material in this book of interest.

S. Y. Lee wishes to thank Dr Lin See Yan, deputy-governor of Bank Negara Malaysia; Dr Arifin Siregar, managing director of Bank Indonesia; Mr Edgardo P. Zialcita, director of Central Bank of the Philippines; Dr Edita A. Tan, professor, University of the Philippines School of Economics; Bank of Thailand; Monetary Authority of Singapore; and numerous bankers, financiers, and government officials in ASEAN for their comments, information and data. The former Nanyang University granted S. Y. Lee some research funds so that he could visit the other four ASEAN countries and Hong Kong to collect data and to interview people. He would like to take this opportunity to express his gratitude.

Y. C. Jao is indebted to Professors A. J. Youngson, F.H.H. King, Mo-huan Hsing, and J. S. G. Wilson, Dr T. B. Lin, and Mr David Li for helpful comments and suggestions for improvement. Needless to say, the authors alone are responsible for whatever errors or omissions that remain.

January 1981

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1

Introduction

This book is concerned with the structure of financial institutions, and the *modus operandi* of monetary policy in six countries in Southeast Asia, namely, Hong Kong, Indonesia, Malaysia, the Philippines, Singapore and Thailand. The purpose of this introductory chapter is to provide a brief explanation of the nature, objective and scope of the study.

To begin with, it is easy to justify the publication of this volume. Two of the countries surveyed, the city-states Hong Kong and Singapore, have already achieved an enviable record of export-led industrialisation and have moreover emerged as important financial centres for the Asian-Pacific region during the past decade. The other four countries, Indonesia, Malaysia, the Philippines and Thailand, are resource-rich economies which, while still at their early stages of industrialisation, are fully committed to economic growth as their top national priority. Furthermore, they, together with Singapore, have been founding members of the Association of Southeast Asian Nations (ASEAN) since 1967. As a regional grouping, ASEAN has in recent years, particularly since the fall of Indochina to the Vietnamese Communists in 1975, become an increasingly important political and economic entity. Any study that aims to analyse the functioning of the financial sector and the working of monetary policy, and to evaluate their role in economic growth and stabilisation in the six countries, must surely be a worthwhile undertaking.

There have been previous publications on the subject, but the rapidly changing financial scenes urgently call for a more up-to-date work. Emery's massive volume, published in 1970 and based on source materials of the 1960s, is clearly dated. Moreover, it is almost entirely confined to a detailed descriptive account of various financial institutions, with only passing references to monetary policy.[1] A more recent book, published in 1973 and edited by Grubel and Morgan, deals with exchange rate policy only in the region.[2] Much of its discussions has also been overtaken by the collapse of the Bretton Woods system, the involuntary transition to a worldwide regime of floating rates, and, of course, the global energy crisis.

There is no lack of single-country studies, including the present authors' books on banking and monetary systems in Hong Kong, Malaysia and Singapore.[3] However, such has been the pace of changes in the individual countries concerned that these books are also badly in need of revision.

More important than the inevitable obsolescence of factual and institutional studies is the current trend in theoretical discussions on the interrelationships between finance and development. While this is no place for a detailed review of the relevant literature, we wish to draw the attention of the readers to two important books, both published in 1973, in which the authors, Shaw and McKinnon, underlined the critical importance of 'financial deepening' for less developed countries (LDCs).[4] In their view, most stagnant economies of the Third World suffer from 'shallow finance' or 'financial repression', characterised by slow growth or even atrophy of financial assets and financial structure, with a depressant effect on the real economy. This sorry state of affairs has been caused by inappropriate policies, marked by a propensity to rely on a multitude of restrictions and controls, a preference for inflation tax, and a reluctance to let interest rates and exchange rates reflect the free play of market forces. Such policies penalise savings and exports, suppress market signals about capital, distort the functioning of financial institutions and markets, and encourage lop-sided development of capital-intensive industries inconsistent with factor endowment and comparative advantage. In contrast, financial liberalisation enables interest rates and exchange rates to reflect relative scarcities, stimulate savings and exports, discriminate more efficiently between alternative investments, and permit financial institutions and markets to grow in a competitive environment. In addition to these beneficial income, saving and investment effects, financial liberalisation also induces replacement of capital-intensive process and technology by labour-intensive ones, and provided the elasticity of substitution between labour and capital is high, positive employment and distribution effects are generated in favour of labour, contributing to both higher growth and more equitable distribution of income. Thus both the financial and real sectors can grow in a mutually stimulating process.

The powerful indictment by Shaw and McKinnon of 'shallow finance' in LDCs has attracted a great deal of attention among economists and policy-makers. A clear measure of their influence is the fact that their thesis of financial deepening and liberalisation has been the subject of a *Festschrift* in honour of Shaw and edited by McKinnon, and a symposium on 'Finance in Developing Countries' in the *Journal of Development Studies*.[5] Both Shaw and McKinnon have singled out South Korea and Taiwan as successful examples of financial deepening, where realistic policies on interest rates and exchange rates and an effective programme of curbing inflation have, in their view, contributed significantly to rapid economic growth in these two countries.[6] Neither of them has, however, mentioned the city-states Hong Kong and Singapore, whose economic success is also attributable, at least partially, to financial deepening and liberalisation. While both books are highly stimulating and thought-provoking, they are mainly concerned with broad theoretical issues only. Recently, one of the present authors, Jao, and Fry have made empirical tests of the Shaw–McKinnon hypothesis. Jao uses data from a large number of countries, both developed and developing (including of course the six countries in this book), during 1967–73, while Fry employs time series data from seven to ten less developed Asian countries during 1962–72.[7] Both studies support the hypothesis that financial conditions influence positively saving and economic growth. However, they should be regarded as initial attempts at verification rather than as conclusive evidence.

Despite its growing influence, the Shaw-McKinnon view is not immune from criticism or scepticism. The Keynesian approach still thinks that savings can be generated by prior investments, and thus moderately inflationary policies can accelerate economic growth in LDCs. The structuralist approach, which continues to exert a powerful influence on economic theory and policy in many LDCs, particularly Latin America, regards inflation as an inevitable consequence of economic growth and structural change. Even a non-Keynesian or a non-structuralist, while agreeing with the main thrust of the Shaw-McKinnon theory, may not endorse fully their description of the exact mechanism through which financial deepening (repression) stimulates (retards) economic development, or some of their specific theoretical arguments and policy prescriptions. Thus, many economists doubt whether the reliance on a high interest-rate policy is sufficient to ensure that the domestic financial market can perform the 'boot strap' function of accelerating economic growth without external capital and finance, and consequently whether McKinnon's dismissal of the 'two-gap' theory is not altogether too cavalier. Their book being written before the world-wide transition to flexible exchange rates, the enthusiasm of Shaw and McKinnon for such a system has also been belied by the actual experience since 1973. Finally, as will be shown in our study of Hong Kong, a policy of full-blooded *laissez-faire* in banking and finance can create vexatious problems of its own.

Thus, although the Shaw–McKinnon thesis of financial deepening and liberalisation provides a useful and timely conceptual framework for analysing and appraising the effectiveness of financial structures and policies in developing countries, the great complexity and variety of national developmental experience impel us to recognise that there is no single model of financial structure and policy suitable at all times to all countries. Any optimal financial structure and/or policy is likely to be country-specific. In this sense we agree