



ELSEVIER

Available online at [www.sciencedirect.com](http://www.sciencedirect.com)

SCIENCE @ DIRECT®

J. Japanese Int. Economies 20 (2006) 128–153

Journal of  
THE JAPANESE  
AND INTERNATIONAL  
ECONOMIES

[www.elsevier.com/locate/jjie](http://www.elsevier.com/locate/jjie)

## The Chinese economies in global context: The integration process and its determinants

Yin-Wong Cheung<sup>a</sup>, Menzie D. Chinn<sup>b,c,\*</sup>, Eiji Fujii<sup>d</sup>

<sup>a</sup> Department of Economics, University of California, Santa Cruz, CA 95064, USA

<sup>b</sup> LaFollette School, and Department of Economics, University of Wisconsin, 1180 Observatory Drive,  
Madison, WI 53706-1393, USA

<sup>c</sup> NBER, USA

<sup>d</sup> Graduate School of Systems and Information Engineering, University of Tsukuba, Tennodai 1-1-1,  
Tsukuba, Ibaraki, Japan

Received 18 February 2004; revised 4 November 2004

---

**Cheung, Yin-Wong, Chinn, Menzie D., and Fujii, Eiji**—The Chinese economies in global context: The integration process and its determinants

The linkages between the People's Republic of China and the other Chinese economies of Hong Kong and Taiwan are assessed, and compared against those with Japan and the US. We first characterize the time series behavior of three criteria of integration, namely real interest parity, uncovered interest parity, and relative purchasing power parity. There is evidence that these parity conditions tend to hold over longer periods between the People's Republic of China and all other economies, although they do not hold instantaneously. Overall, the magnitude of deviations from the parity conditions is shrinking over time. Amongst all, however, Hong Kong exhibits indications of a more advanced level of integration with the mainland. We also find that evidence is surprisingly positive for integration with the US. We then turn to examining the determinants of the degree of integration. Regression results suggest that the degree of financial and real integration depend upon the extent of capital controls, foreign direct investment linkages as well as exchange rate volatility. *J. Japanese Int. Economies* 20 (1) (2006) 128–153. Department of Economics, University of California, Santa Cruz, CA 95064, USA; LaFollette School, and Department of Economics, University of Wisconsin, 1180

---

\* Corresponding author.

E-mail addresses: [cheung@ucsc.edu](mailto:cheung@ucsc.edu) (Y.-W. Cheung), [mchinn@lafollette.wisc.edu](mailto:mchinn@lafollette.wisc.edu) (M.D. Chinn), [efujii@sk.tsukuba.ac.jp](mailto:efujii@sk.tsukuba.ac.jp) (E. Fujii).

Observatory Drive, Madison, WI 53706-1393, USA; NBER, USA; Graduate School of Systems and Information Engineering, University of Tsukuba, Tennodai 1-1-1, Tsukuba, Ibaraki, Japan.

© 2005 Elsevier Inc. All rights reserved.

*JEL classification:* F31; F41

*Keywords:* Uncovered interest parity; Real interest parity; Purchasing power parity; Exchange rates; Capital mobility; Market integration

---

## 1. Introduction

The economies of China—the People’s Republic, Hong Kong and Taiwan—constitute one of the most dynamic regions of the world economy, with the People’s Republic of China (PRC) registering economic growth over 9% in the year ending in the third quarter of 2004. Perhaps of equal significance, the combined output of these three economies is almost twice that of Japan’s, and over 60% that of the US. In addition, their foreign exchange reserves are among the largest in the world.<sup>1</sup> Yet it is unclear whether one can treat the region as an integrated whole; indeed, there has been little systematic examination of whether the links between the PRC and the other two Chinese economies are any stronger than those that connect the PRC to other major economies in the rest of the world, such as Japan or the US.

Since the initiation of its economic reforms, the PRC has been engaged in a process of financial and real integration with the rest of the world. For both geopolitical and economic reasons, the PRC, Hong Kong, and Taiwan have maintained close economic ties. Hong Kong has a quite long history of economic and financial interactions with the PRC. Perhaps more surprising to a casual observer, despite political and ideological differences and occasional tensions between the PRC and Taiwan, economic links between these two economies have proliferated since the 1990s. According to official statistics, the PRC is the largest recipient of Taiwan’s overseas investment and Taiwan is the PRC’s third-largest source of foreign direct investment.<sup>2</sup>

The US and Japan are the PRC’s main trading partners and foreign investors. In 2002 the total trade (imports plus exports) between the PRC and each of the two economies was about US\$100 billion. Foreign direct investment flows to China have also been burgeoning. The US to the PRC flows were US\$5.4 billion in 2002, while those from Japan were between US\$4.2 billion. Evidently, linkages of many forms have been expanding between these economies over the last decade or so.

---

<sup>1</sup> As of September 2004, the reserves of Hong Kong and Taiwan were, respectively, US\$118.4 and US\$233.0 billion. Those of the People’s Republic of China were US\$514.5 billion in February (*Economist*, October 30–November 5, 2004).

<sup>2</sup> It is widely believed that the official statistics under-represent overall Taiwanese economic interests in China. For instance, some analysts tabulate Taiwan’s total investment in China as just behind that of Hong Kong’s but ahead of that of the US. In 2002, electronics companies from Taiwan account for 64% of the PRC’s total information-technology output (*The Economist Intelligence Unit*, 2003).

In this paper, we examine some macroeconomic aspects of the PRC's economic integration with Hong Kong, Taiwan, Japan, and the US. Despite its increasing importance in the world economy, there are a relatively limited number of studies on the PRC's interactions with other economies. This is not to say that there has not been any quantitative analysis on the subject. Especially in the period surrounding the PRC's accession to the World Trade Organization, a number of quantitative analyses mostly focused on sectoral/trade issues were conducted.<sup>3</sup> However, a thoroughgoing investigation of financial and price linkages is notably lacking.<sup>4</sup>

Besides assessing the integration between the PRC and the other four economies, the current study evaluates whether the patterns of integration between the PRC and the other two greater China economies and those between the PRC and Japan and the US differ. We believe that such an investigation is warranted as there has been much talk of an economic entity comprising the PRC, Hong Kong and Taiwan. This entity is variously termed "Greater China" or the "China Circle."<sup>5</sup>

Three fundamental parity conditions—real interest parity, uncovered interest parity, and purchasing power parity—are used to gauge the degrees of integration in capital, financial, and goods markets. The real interest parity condition measures the mobility of physical capital, specifically whether capital flows equalize real interest rates across economies. It can be shown that the degree to which real interest rate parity holds depends on the extent to which uncovered interest parity and relative purchasing power parity apply. Since uncovered interest parity involves financial arbitrage between money and foreign exchange markets and relative purchasing power parity entails arbitrage in goods and services, the real interest parity condition embodies elements of both real and financial integration.

In addition to characterizing these linkages, we also document how the strength of each of these links depends on a number of regulatory and economic factors. We ask, for instance, how much of the gap between real rates of return depends upon the extent of capital controls, and how much might be due to the uncertainty associated with macroeconomic policies (as summarized by exchange rate and inflation volatility).

The plan of the paper is as follows. In Section 2, we lay out a framework for systematically analyzing the components of financial and real integration—corresponding to deviations from uncovered interest parity and relative purchasing power parity. In Section 3, we present some descriptive statistics of parity differential series and examine their compositions. In the same section, we also study the properties of these disparity series, in terms of their stationarity characteristics, persistence, and trends. Section 4 examines how these deviations can be related to economic factors. Some concluding remarks are offered in Section 5.

---

<sup>3</sup> Recent analyses focused on WTO effects include Wang (2001) and Ma (2001). Other quantitative analyses of trade linkages include Wei and Frankel (1994), Wei et al. (2000), Noland et al. (1998), and Fernald et al. (1999). For a general survey, see Prasad (2004).

<sup>4</sup> Ha and Fan (2002) and Shellekens (2002) study the interactions of prices in the PRC and Hong Kong and the deflationary effect on Hong Kong. Cheung et al. (2003) investigate intra-China linkages.

<sup>5</sup> Harding (1995) used the term "Greater China" while Naughton (1997) popularized the title "China Circle."

## 2. Aspects of capital market integration

There are a number of definitions of capital market integration, each with its own strengths and weaknesses. We adopt several specific definitions due to Frankel (1991). First, we equate real interest parity with real capital mobility. The real interest parity condition is underpinned by two other conditions—uncovered interest parity and relative purchasing power parity. The latter two conditions represent financial capital market integration and goods market integration, respectively.

### 2.1. An accounting identity

Consider the ex ante real interest differential between two economies:

$$r_{t,k}^e - r_{t,k}^{*e} \equiv (i_{t,k} - \pi_{t,k}^e) - (i_{t,k}^* - \pi_{t,k}^{*e}) \quad (1)$$

where  $r_{t,k}^e$  is the expected  $k$ -period real interest rate in the first economy with the superscript “ $e$ ” indicating the variable is expected and the subscript “ $k$ ” the maturity of the debt instrument. The “ $*$ ” denotes the variables for the second economy. The real interest rate is given by the difference between  $i_{t,k}$ , the  $k$ -period nominal interest rate, and  $\pi_{t,k}^e$ , the expected inflation rate in  $k$  periods. Hence, Eq. (1) defines the ex ante real interest rate as the nominal interest rate on an asset of  $k$ -period maturity, deflated by the inflation rate expected at time  $t$  to prevail over the period  $t$  to  $t+k$  (annualized).<sup>6</sup> The expected inflation is defined by

$$\pi_{t,k}^e \equiv p_{t,k}^e - p_t, \quad (2)$$

where  $p_{t,k}^e$  and  $p_t$  are, respectively, the price (in log) expected to prevail at  $t+k$  and the price at  $t$ . The expected inflation in the second economy is similarly defined by

$$\pi_{t,k}^{*e} \equiv p_{t,k}^{*e} - p_t^*. \quad (3)$$

The expression for the real interest differential on the right-hand side of (1) can be rearranged, and expected depreciation subtracted and added, to yield:

$$r_{t,k}^e - r_{t,k}^{*e} \equiv (i_{t,k} - i_{t,k}^* - \Delta s_{t,k}^e) - (\pi_{t,k}^e - \pi_{t,k}^{*e} - \Delta s_{t,k}^e), \quad (4)$$

where expected depreciation is given by

$$\Delta s_{t,k}^e \equiv s_{t,k}^e - s_t \quad (5)$$

and  $s_t$  is the exchange rate between monies in the two economies expressed in logarithm. Note that the first term on the right-hand side of (4) is the uncovered interest differential, and the second term is the deviation from ex ante relative purchasing power parity. The uncovered interest differential should equal zero when financial capital is perfectly mobile and substitutable; the deviation from purchasing power parity should be zero when goods markets are perfectly integrated.

<sup>6</sup> In this case, we are assuming that the interest rates are on highly liquid, money market instruments of identical default risk characteristics. Hence, we do not address default risk premia in our discussion.

## 2.2. Empirical implementation

Strictly speaking, real interest parity is an ex ante concept defined by expectations rather than realized real interest rates. The theoretical relationship between the three parity conditions is defined by identity (4). However, due to the paucity of data on expectations, the identity cannot be used to directly assess the empirical relevance of these parity conditions. Instead, we employ an operational version based on ex post differentials,

$$r_{t,k} - r_{t,k}^* \equiv (i_{t,k} - i_{t,k}^* - \Delta s_{t,k}) - (\pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k}) \quad (6)$$

to examine the data. One way to justify the use of (6) is that, under the rational expectations hypothesis, the ex post realizations are unbiased predictors of the ex ante counterparts.<sup>7</sup> Since there is substantial evidence that expectations are not unbiased,<sup>8</sup> we will simply refer to the term on the left-hand side of (6) as the deviation from ex post real interest parity, and the two terms on the right-hand side as the deviation from ex post uncovered interest parity and from ex post relative purchasing power parity.

## 2.3. Financial versus real integration

Abstracting from the distinction between ex ante and ex post, Eqs. (4) and (6) imply that a sufficient condition for real interest parity to hold is that both uncovered interest parity and relative purchasing power parity hold. While uncovered interest parity pertains to financial integration driven by arbitrage between money and foreign exchange markets—that is, how desirable currencies are viewed and how free money is to move—relative purchasing power parity pertains to how easily goods and services are arbitrated. Hence, real interest parity is a function of *both* financial and real market integration (Frankel, 1991).

To make this assertion concrete, consider a situation where financial markets in two economies were well integrated, while differential inflation rates were not offset by changes in exchange rates. Then real interest differentials could persist not because financial capital flows were hindered and uncovered interest parity is violated, but because of the breakdown of relative purchasing power parity due to the limited strength of the forces that drive together goods prices (expressed in a common currency).

The condition wherein real interest rate parity holds is sometimes termed real capital mobility. That is, real interest rates are equalized when “real” capital is free to move. To see why some observers make this equivalence, consider basic microeconomic theory. An optimizing firm sets the marginal product of capital equal to the user cost of capital. Absent taxes (and ignoring depreciation), the user cost of capital is the nominal interest rate,

<sup>7</sup> In other words, we are equating the subjective market expectations with the conditional mathematical expectations, viz.  $x_{t+k}^e = E(x_{t+k} | I_t)$ , in a steady state such that  $x_{t+k} - E(x_{t+k} | I_t) = \xi_{t+k}$  where  $\xi_{t+k}$  is a true innovation.

<sup>8</sup> See Frankel and Froot (1997) and Chinn and Frankel (1994).

adjusted by the rate of inflation of its output. Hence real interest parity is taken as a signal of the equalization of the marginal product of capital.<sup>9</sup>

### 3. Empirical results

The data utilized are monthly observations on one-month interbank interest rates, exchange rates, and consumer price indexes for the PRC, Hong Kong, Taiwan, Japan, and the US, from February 1996 to June 2002. See Appendix A for a more detailed description. The period of analysis is dictated by data availability, and more importantly, by the realities of the liberalization process in the PRC. A unified national interbank market was only established in January of 1996; prior to that the interbank market was substantially controlled (Xie, 2002). Hence, extending the interest rate series backwards would not yield more information relevant to assessing financial integration.<sup>10</sup>

For each pair of economies, the ex post real interest differential ( $r_{t,k} - r_{t,k}^*$ ), ex post uncovered interest differential ( $i_{t,k} - i_{t,k}^* - \Delta s_{t,k}$ ), and ex post relative purchasing power differential ( $\pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k}$ ) are constructed to examine the relevance of the parity conditions and infer the degree of integration between the PRC and other economies. For simplicity, we drop the term “ex post” hereafter.

Table 1 presents the summary descriptive statistics. Several observations are in order. First, for the real interest differential, the Hong Kong/PRC series has the smallest mean (in absolute value), but neither the smallest range (maximum – minimum), nor the smallest variance. If these numbers are used to assess integration, then Hong Kong and the PRC do not appear to have the highest level of integration.<sup>11</sup>

However, recall that the deviations from real interest parity are a composite of other deviations. When one focuses solely on the financial side, the deviation from uncovered interest parity tells a different story. Hong Kong/PRC and US/PRC appear the most tightly linked, with the smallest absolute mean values and smallest ranges. The Japan/PRC pair yields the largest absolute value of the mean differential deviation. The result is likely driven by the exchange rate arrangements adopted by the PRC. During the sample period, currencies of the PRC and Hong Kong are effectively pegged to the US dollar and, thus, the exchange rate has a limited effect on the uncovered interest deviations. On the other hand, Japan/PRC is characterized by large and volatile exchange rate variation and thus large deviations from the uncovered interest parity.

The deviations from purchasing power parity are generally fairly small in their mean values with the exception of the Japan/PRC link. The range is smallest for the Hong

<sup>9</sup> There is a subtlety involved in using parity conditions to evaluate the level of integration. When a parity condition is rejected, then enlargements and diminutions of deviations may be due to either greater economic integration, greater convergence of economic policies, or both.

<sup>10</sup> There is a separate question of whether the one-month rate is representative of other short-term interest rates, including the commercial paper and repo rates. Li and Peng (2002) argue that in recent years the segmentation in these short-term instruments has largely disappeared.

<sup>11</sup> In the presence of a 1997 dummy variable, the Taiwan/PRC pair, instead of the Hong Kong/PRC pair, has the smallest absolute average real interest differential.

Table 1  
Descriptive statistics

	Hong Kong/PRC	Taiwan/PRC	US/PRC	Japan/PRC
<i>A. Real interest differentials</i>				
Mean	-0.178	-1.847	-3.245***	-5.289***
Maximum	21.260	19.427	11.056	8.363
Minimum	-20.899	-43.994	-20.383	-16.633
Variance	86.818	114.100	41.161	40.912
<i>B. Uncovered interest differentials</i>				
Mean	-1.276***	-7.274**	-1.718***	-17.382***
Maximum	9.787	51.813	4.434	79.034
Minimum	-9.150	-160.383	-8.377	-128.787
Variance	14.349	714.270	13.964	1744.785
<i>C. Deviations from relative purchasing power parity</i>				
Mean	1.097	5.426*	-1.527**	12.092**
Maximum	22.701	166.622	14.797	130.708
Minimum	-16.187	-62.297	-18.703	-87.654
Variance	57.931	782.878	37.988	1788.675

*Notes.* The real interest differentials, uncovered interest differentials, and deviations from relative purchasing power parity are all annualized and measured in percentage terms. The economy-pairs are labeled in the first row.

\* The sample mean is significantly different from zero at the 10% level.

\*\* Idem., 5%.

\*\*\* Idem., 1%.

Kong/PRC and US/PRC pairs in which the exchange rates are pegged. Again, the results suggest that the choice of an exchange rate regime has a marked impact on the magnitude of the disparity.

To gain further insight, we decompose the variance of the differential series in order to identify the relative contributions of various components to total variation.<sup>12</sup> The variance of real interest differentials can be equivalently written as

$$\begin{aligned} \text{Var}(r_{t,k} - r_{t,k}^*) &\equiv \text{Var}(i_{t,k} - i_{t,k}^* - \Delta s_{t,k}) + \text{Var}(\pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k}) \\ &\quad - 2 \text{Cov}(i_{t,k} - i_{t,k}^* - \Delta s_{t,k}, \pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k}). \end{aligned} \quad (7)$$

The intensity of deviations from real interest parity depends on the extents of financial and goods market non-integration and the co-movement between deviations from uncovered

<sup>12</sup> The variance of a differential series provides a measure of the extent of deviation from a parity condition, and hence, has been used to assess the degree of market integration (Engel and Rogers, 1996; Parsley and Wei, 2001). For example, if a parity condition holds instantaneously, then its differential series will be identically equal to zero. If the parity is subject to large shocks, then the variance of the differential series is large. Thus, a large differential variance is indicative of substantial deviation from the parity condition. There are, however, two caveats. The first is that the ex post deviations impound an expectational error, so larger deviations can be consistent with increased uncertainty. Second, even a constant deviation from the parity yields a zero variance. Due to impediments to capital flows including formal barriers and transaction costs, the parity condition may not hold exactly in reality. The impediments can create a zone in which it is not feasible for arbitrage to restore the parity. Under such circumstances, the observed differential series does not have a zero mean and its variance can be interpreted as a measure of deviation from parity *allowing for the effect of impediments to capital flows*.

interest parity and relative purchasing power parity. The decomposition of  $\text{Var}(r_{t,k} - r_{t,k}^*)$  using actual data can pinpoint whether it is the barriers in financial markets or in goods markets that cause the failure to equalize real interest rates.

By the same token, the variances of uncovered interest and relative purchasing power differentials can be expressed as

$$\begin{aligned} \text{Var}(i_{t,k} - i_{t,k}^* - \Delta s_{t,k}) &\equiv \text{Var}(i_{t,k} - i_{t,k}^*) + \text{Var}(\Delta s_{t,k}) \\ &\quad - 2 \text{Cov}(i_{t,k} - i_{t,k}^*, \Delta s_{t,k}) \end{aligned} \quad (8)$$

and

$$\begin{aligned} \text{Var}(\pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k}) &\equiv \text{Var}(\pi_{t,k} - \pi_{t,k}^*) + \text{Var}(\Delta s_{t,k}) \\ &\quad - 2 \text{Cov}(\pi_{t,k} - \pi_{t,k}^*, \Delta s_{t,k}). \end{aligned} \quad (9)$$

Equations (7), (8) and (9) allow us to assess the roles of nominal interest rates, exchange rate changes, relative inflation rates, and their co-movements on deviations from the parities.

The decomposition results based on (7), (8), and (9) are presented in Table 2. For real interest differentials the Japan/PRC pair has the smallest variance while the Taiwan/PRC pair has the largest one. The relative contributions of uncovered interest disparity and relative purchasing power disparity are different across these economy-pairs. The Hong Kong/PRC and US/PRC pairs are similar—the variances of uncovered interest and relative purchasing

Table 2  
Decomposition of parity differential variances

	Hong Kong/PRC	Taiwan/PRC	US/PRC	Japan/PRC
A. Var(RID)	86.818	114.100	41.161	40.912
% Var(UID)	16.528	626.002	33.925	4264.629
% Var(RPD)	66.726	686.132	92.290	4371.903
% -2Cov	16.744	-1212.134	-26.215	-8536.533
B. Var(UID)	14.349	714.270	13.964	1744.785
% Var( $i - i^*$ )	95.286	1.303	93.945	0.746
% Var( $\Delta s$ )	3.791	97.400	0.955	96.635
% -2Cov	0.922	1.295	5.099	2.617
C. Var(RPD)	57.931	782.878	37.988	1788.675
% Var( $\Delta p - \Delta p^*$ )	98.950	14.086	99.674	1.881
% Var( $\Delta s$ )	0.939	88.864	0.351	94.497
% -2Cov	0.110	-2.950	-0.025	3.621

Notes. (i) The economy-pairs are labeled in the first row. (ii) Panel A gives the variance of real interest differentials and its components according to Eq. (7). Var(RID) gives  $\text{Var}(r_{t,k} - r_{t,k}^*)$ , % Var(UID) gives the percentage contribution of  $\text{Var}(i_{t,k} - i_{t,k}^* - \Delta s_{t,k})$ , % Var(RPD) gives the percentage contribution of  $\text{Var}(\pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k})$ , and % -2Cov gives the percentage contribution of the covariance term. (iii) Panel B gives the variance of real interest differentials and its components according to Eq. (8). Var(UID) gives  $\text{Var}(i_{t,k} - i_{t,k}^* - \Delta s_{t,k})$ , % Var( $i - i^*$ ) gives the percentage contribution of  $\text{Var}(i_{t,k} - i_{t,k}^*)$ , % Var( $\Delta s$ ) gives the percentage contribution of  $\text{Var}(\Delta s_{t,k})$ . (iv) Panel C gives the variance of relative PPP differentials and its components according to Eq. (9). Var(RPD) gives  $\text{Var}(\pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k})$ , % Var( $\Delta p - \Delta p^*$ ) gives the percentage contribution of  $\text{Var}(\pi_{t,k} - \pi_{t,k}^*)$ .

power differentials are smaller than that of real interest differentials. In the case of Hong Kong/PRC, 66.7% of the variation is attributable to relative purchasing power variability and 16.7% to uncovered interest variability. For the US/PRC real interest differential variance, slightly more than 90% is attributable to relative purchasing power parity variability and 34% to uncovered interest variability.

In contrast, the variances of the Japan/PRC and Taiwan/PRC real interest differentials are much smaller than those of their components. Specifically, the variances of uncovered interest and relative purchasing power differentials are at least 40 times larger than the variance of real interest difference for Japan/PRC and at least 6 times for Taiwan/PRC. A negative co-movement between its two components keeps the variances of real interest differentials of Japan and Taiwan in the same order of magnitude as those obtaining for the Hong Kong and the US links. That is, individually, the real interest and relative purchasing power disequilibria between the PRC, Japan, and Taiwan are large, but they tend to offset each other (though not perfectly) and result in relatively small deviations in the real interest market.

The decomposition results for uncovered interest and relative purchasing power differentials can be summarized quite simply. The variances of the Japan/PRC and Taiwan/PRC pairs are higher than those of the Hong Kong/PRC and US/PRC pairs. For the two former cases, exchange rate variation is the main contribution to variability while, for the latter two cases, relative price and relative interest variations are the main determinants.

The pattern of results reflects the exchange rate arrangements of these economies. As already noted, both Hong Kong and the PRC effectively pegged their currencies to the US dollar during the sample period; hence the Chinese exchange rate regimes relative to the US and to Hong Kong are de facto pegs. In contrast, Taiwan and Japan are best characterized as following a policy of managed floating. When exchange rates are floating, exchange rate variability accounts for almost the entire variability of the deviations from parity. The situation is exactly reversed when the exchange rate is pegged. Thus, the exchange rate arrangement has significant implication for using these parity conditions as a measure of integration.<sup>13</sup>

The assessment provided above can be also confirmed visually by [Figs. 1 to 4](#), which plot the three differential series for each of the PRC pairs. Taking the scale of these graphs into consideration, the three differential series of the four PRC pairs display two distinct patterns. [Figures 1 and 3](#) indicate that the real interest differentials of the Hong Kong/PRC and US/PRC pairs are greatly influenced by the deviations from the relative purchasing power parity. On the other hand, [Figs. 2 and 4](#) depict that the uncovered interest differentials and deviations from the relative purchasing power parity of the Japan/PRC and Taiwan/PRC tend to offset each other and result in a relatively small real interest differential. This observation corroborates the numbers reported in [Table 1](#)—the averages of the

---

<sup>13</sup> Our sample includes the 1997 Asian currency crisis, an event that exerted strong downward pressure on the currencies of the three Chinese economies. While PRC and Hong Kong defended their dollar pegs, the New Taiwan dollar, under a managed float, experienced a sizable depreciation. The Japanese yen also lost substantially value against the dollar. These experiences highlight the contrasting effects of the alternative exchange rate arrangements.

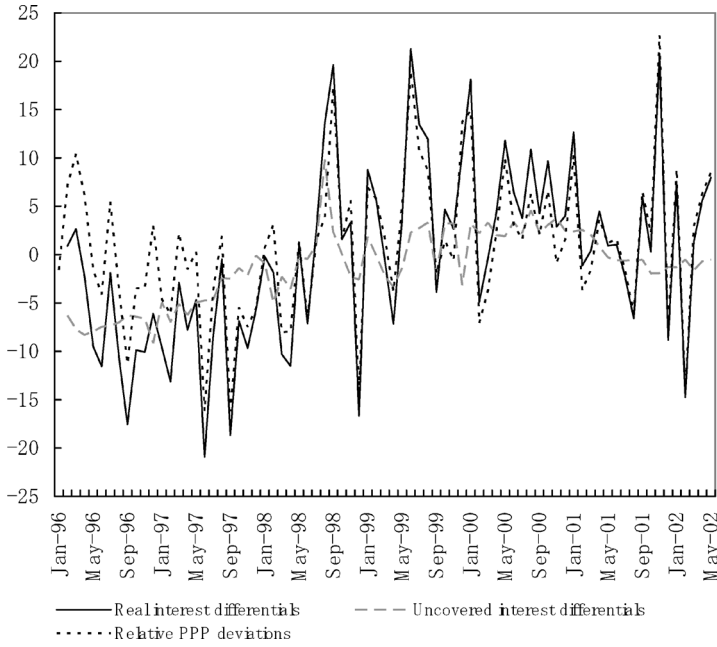


Fig. 1. Deviations from the parity conditions between Hong Kong and PRC.

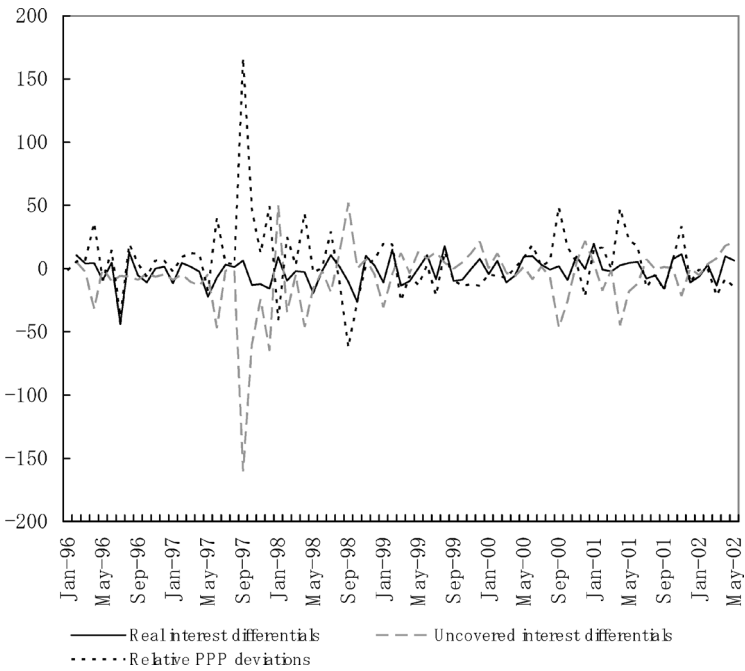


Fig. 2. Deviations from the parity conditions between Taiwan and PRC.

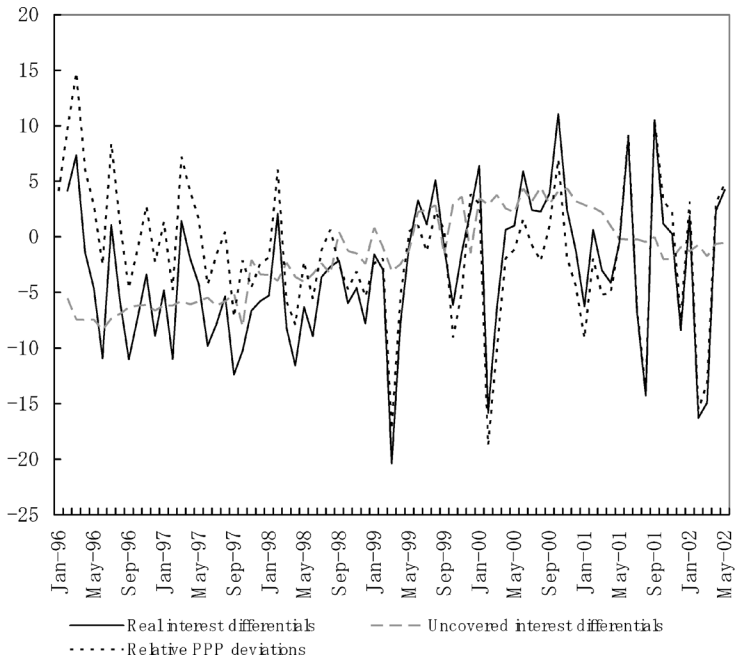


Fig. 3. Deviations from the parity conditions between US and PRC.

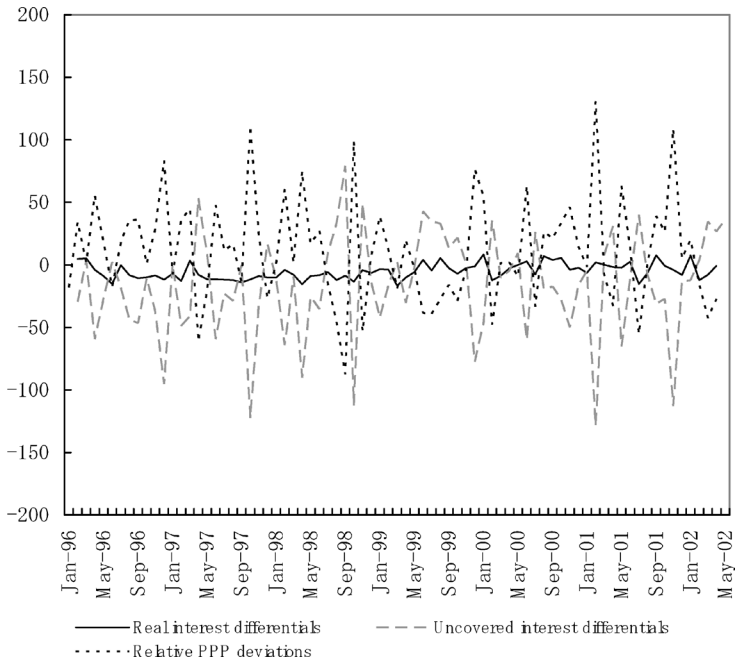


Fig. 4. Deviations from the parity conditions between Japan and PRC.

Japan/PRC and Taiwan/PRC real interest differentials are considerably smaller than those of the other two differential series.

In the following subsections, we provide a formal evaluation of the parity conditions via several perspectives. First, we test for the presence of a unit root in these differential series. Second, we gauge the predictive ability of the past values of the differential series. Third, we assess whether the deviations from parity conditions are shrinking over time or not.

### 3.1. Real interest parity

In some earlier studies, regression methods are used to determine the validity of real interest parity (Cumby and Obstfeld, 1984). For example, interest rate differentials are regressed on inflation differentials and the coefficient estimates are used to assess whether the real interest rate parity condition holds.<sup>14</sup> In this study, we use the concept of mean stationarity to evaluate the parity condition. If the deviations from real interest parity are stationary, then even if the condition does not hold in the short run, it holds in the long run because deviations from parity are transitory. The argument follows from the property of a stationary time series—a stationary time series will revert back to its equilibrium value after being disturbed by external shocks. On the other hand, if the deviations from parity are not stationary, shocks can lead to permanent displacements from equilibrium and there is no built-in mechanism to restore the parity condition even in the long run.<sup>15</sup> The use of the stationarity criterion is appropriate because a parity relation is usually posited under some ideal conditions that are unlikely to hold in the short run. The stationarity criterion can also be rationalized by recalling that we only observe ex post inflation and depreciation rates; hence it makes no sense to assume that the ex post parity conditions hold instantaneously. As long as the parity conditions hold ex ante and the expectations errors are mean stationary, tests for stationarity will be informative.

A modified Dickey–Fuller test known as the ADF–GLS test (Elliott et al., 1996) is used to test for stationarity. While the standard Dickey–Fuller procedure is notorious for its low power, the ADF–GLS test is shown to be approximately uniformly most powerful invariant. Consider a series  $\{q_t\}$ ;  $q_t$  = real interest differential, uncovered interest differential, and relative purchasing power differential at time  $t$ . The ADF–GLS <sup>$\tau$</sup>  test that allows for a linear time trend is based on the following regression:

$$(1 - L)q_t^\tau = \alpha_0 q_{t-1}^\tau + \sum_{k=1}^p \alpha_k (1 - L)q_{t-k}^\tau + \varepsilon_t, \quad (10)$$

<sup>14</sup> There is an extensive literature on testing real interest parity. See Mishkin (1984), Mark (1985), and Cumby and Mishkin (1986). In some studies, exact formula for calculating interest rate variables (instead of log approximations) are typically used in the context of testing for real interest parity. However, the calculations derived using the exact formulae and log approximations yield qualitatively similar test results. Following general practice, the test results in Tables 2 to 5 are based on the log approximation.

<sup>15</sup> The constant associated with the real interest parity deviation can be interpreted as a time-invariant difference in the default risk or liquidity attributes of the money market instruments that have been assumed away in the algebraic expressions.

where  $q_t^\tau$  is the locally detrended process under the local alternative of  $\bar{\alpha}$  and is given by

$$q_t^\tau = q_t - \tilde{\gamma}' z_t, \quad (11)$$

$z_t = (1, t)' \cdot \tilde{\gamma}$  being the least squares regression coefficient of  $\tilde{q}_t$  on  $\tilde{z}_t$ , with  $(\tilde{q}_1, \tilde{q}_2, \dots, \tilde{q}_T) = (q_1, (1 - \bar{\alpha}L)q_2, \dots, (1 - \bar{\alpha}L)q_T)$  and  $(\tilde{z}_1, \tilde{z}_2, \dots, \tilde{z}_T) = (z_1, (1 - \bar{\alpha}L)z_2, \dots, (1 - \bar{\alpha}L)z_T)$ ; and  $L$  is the lag operator. The local alternative  $\bar{\alpha}$  is defined by  $\bar{\alpha} = 1 + \bar{c}/T$  for which  $\bar{c}$  is set to  $-13.5$ . The ADF-GLS $^\mu$  test, which allows for only an intercept, involves the same procedure as the ADF-GLS $^\tau$  test, except that  $q_t^\tau$  is replaced by the locally demeaned series  $q_t^\mu$ , which is obtained by setting  $z_t = 1$  and  $\bar{c}$  to  $-7$ . In implementing the test, the lag parameter  $p$  is chosen to make the error term  $\varepsilon_t$  a white noise process. The unit root hypothesis is rejected when the ADF-GLS test statistic, which is given by the usual  $t$ -statistic for  $\alpha_0 = 0$  against the alternative of  $\alpha_0 < 0$ , is significant. See Elliott et al. (1996) for a detailed description of the testing procedure.

The results of applying the ADF-GLS $^\tau$  and ADF-GLS $^\mu$  tests to the four real interest differential series are presented in panel A of Table 3. For all the three series, the residual  $Q$ -statistics indicate that the selected lag specifications are quite adequate. Both the ADF-GLS $^\tau$  and ADF-GLS $^\mu$  test statistics are negative and significant; suggesting that the real interest differential series are stationary. That is the deviations from real interest parity are stationary and tend to converge over time.

Panel B of Table 3 reports the results of the following regression:

$$q_t = \alpha_0 + \sum_{k=1}^p \alpha_k q_{t-k} + \varepsilon_t. \quad (12)$$

The regression is used in some previous studies assessing the parity condition. Under *instantaneous* real interest parity, the expected real interest differential is random, has a zero mean, and cannot be predicted by available information. Thus, the significance of  $\alpha_k$  in (12) is considered as evidence against the validity of the (instantaneous) parity condition.

As reported in panel B, all the four PRC real interest differential series display significant persistence. Deviations from the real interest parity are predictable and the markets are not efficient in this sense. Thus, the results indicate that the PRC is imperfectly integrated with the other economies—a finding that is not surprising because the PRC has strict controls on both trade and financial flows. Nonetheless, despite the limited extent of integration and the failure of short-run real interest parity, the stationarity results in panel A suggest that the real interest rates of PRC and all other economies are linked in the long run and they do not drift apart without a bound over time.

The explained components of these differential series, as indicated by the adjusted- $R^2$ , range from 4.5% of the US/PRC real interest differentials to 19.2% of the Taiwan/PRC differentials. The adjusted- $R^2$  from the Hong Kong/PRC and Taiwan/PRC regressions are larger than those from the other two pairs. Apparently, the real interest differentials between the Greater China economies are more predictable than those between the PRC and the two non-Chinese economies.

Next, we use a simple panel setting to reveal the possible trending behavior of disparity. Specifically, we would like to investigate whether the magnitude of deviation is declining during the sample period. To this end, we construct an annual measure of *absolute* deviation

Table 3  
Real interest differentials

	Hong Kong/PRC	Taiwan/PRC	US/PRC	Japan/PRC
<i>A. Unit root test statistics</i>				
ADF–GLS <sup>μ</sup>	−3.626** [3]	−2.358** [6]	−3.195** [4]	−2.436** [4]
Q(6)	10.067	0.642	0.385	0.957
Q(12)	17.192	3.967	16.055	10.715
ADF–GLS <sup>τ</sup>	−7.187** [1]	−4.996** [5]	−6.684** [1]	−7.145** [1]
Q(6)	8.442	10.574	5.402	6.532
Q(12)	13.866	15.265	16.088	13.956
<i>B. Persistence</i>				
AR(1)	0.270** (0.120)	−0.231** (0.107)	0.241** (0.121)	0.168 (0.117)
AR(2)	0.250** (0.121)	−0.175 (0.111)	−0.118 (0.125)	0.080 (0.120)
AR(3)	−0.063 (0.120)	−0.053 (0.113)	0.068 (0.126)	0.035 (0.120)
AR(4)	—	−0.001 (0.113)	0.171 (0.125)	0.285** (0.120)
AR(5)	—	0.136 (0.111)	—	—
AR(6)	—	0.420*** (0.108)	—	—
Adjusted R <sup>2</sup>	0.124	0.192	0.045	0.103
<i>C. Trends in annual absolute averages</i>				
Individual	−0.484* (0.208)	−0.471 (0.283)	−0.277 (0.166)	−0.961** (0.334)
Group		−0.478** (0.162)		−0.619** (0.219)
Common			−0.548*** (0.128)	

Notes. (i) Results on the properties of real interest differentials are presented. The economy-pairs are labeled in the first row. (ii) Panel A gives the ADF–GLS<sup>τ</sup> and ADF–GLS<sup>μ</sup> unit root test results. Levels of significance are determined using finite sample critical values (Cheung and Lai, 1995). Figures in square brackets are lag parameters selected by the Bayesian information criterion. Q(6) and Q(12) are the Box–Ljung Q-statistics based on the first six and twelve autocorrelations of the estimated residuals. (iii) Panel B gives the persistence of real interest differentials estimated from Eq. (12). (iv) Panel C gives the common and economy-pair (individual) specific trend estimates of the annual average of absolute real interest differentials (Eq. (14)). (v) Robust standard errors are reported in parentheses underneath coefficient estimates.

\* The sample mean is significantly different from zero at the 10% level.

\*\* Idem., 5%.

\*\*\* Idem., 1%.

by averaging the monthly *absolute* real interest differentials. Specifically, we calculate:

$$\tilde{q}_{j,t} = 12^{-1} \sum_{k=1}^{12} \text{abs}(q_{j,t,k}) \quad (13)$$

where  $\text{abs}(q_{j,t,k})$  is the absolute value of the real interest rate differential between economy  $j$  and the PRC in the  $k$ th month during year  $t$ ;  $j =$  Hong Kong, Japan, Taiwan, and the US; and  $t = 1996, \dots, 2001$ .<sup>16</sup> We then estimate a common trend in the obtained average absolute deviations by running a panel regression:

$$\tilde{q}_{j,t} = \alpha_j + \beta t + \varepsilon_{j,t} \quad (14)$$

and report the results in Table 3, panel C. The economy-specific intercept term  $\alpha_j$  allows individual absolute deviation series to have different means. The estimated common trend term reported in the row labeled “Common” is statistically significant and negative, suggesting that magnitude of real interest rate differentials is, in general, shrinking over time.

It is useful to identify which economy is the major source of the general decline in the absolute deviation from real interest parity. For this reason, we estimate trend coefficients between the PRC and (1) the other Greater China economies, (2) Japan and the US, and (3) individual economies. The results are reported in the row labeled “Group” and “Individual.” All these trend coefficient estimates are negative—indicating that the PRC real interest rate gap tends to dwindle over time vis-à-vis other economies. The most notable decline is between the PRC and Japan as manifested by both the size and the statistical significance of the trend coefficient estimate. In sum, there is evidence that the PRC is increasingly linked with the other major economies.<sup>17</sup> This finding is robust to the inclusion of a dummy for the 1997 currency crisis.<sup>18</sup>

### 3.2. Uncovered interest parity

The real interest parity condition incorporates aspects of both financial and real integration. Although the results in the previous subsection are supportive of long-run real interest parity, it is instructive to isolate the sources of rejection of short-run integration. To this end, we examine the cases of financial and real integration individually. The results related to financial integration are given in Table 4, in a format analogous to that used in Table 3.

Panel A presents the results of applying the unit root tests on the uncovered interest differential series. For all pairs, excepting the US/PRC, the unit root hypothesis is strongly rejected by both ADF–GLS<sup>τ</sup> and ADF–GLS<sup>μ</sup> test statistics. When a dummy variable for the 1997 crisis is included, the US/PRC series exhibits stationarity.<sup>19</sup> Thus, after ac-

<sup>16</sup> The year 2002 is excluded because we have only 6 observations for that year.

<sup>17</sup> Nonetheless, it is not straightforward to quantify the rate at which disparity is shrinking from these coefficient estimates. For instance, the dependent variable of (14) is the average of monthly absolute deviations. Also, the negative trend term should properly be interpreted as a description of in-sample behavior that does not necessarily extend beyond the sample period. Otherwise, one has to deal with the issue of a “negative” absolute deviation.

<sup>18</sup> The sensitivity to the 1997 dummy is investigated for all results reported in the tables. The reported results are quite robust to the inclusion of the dummy variable. To conserve space, the results allowing for the dummy are discussed only when they are different from those in the tables.

<sup>19</sup> The results for US/PRC pair with the 1997 dummy are (1) ADF–GLS<sup>μ</sup> =  $-2.869^*$  [1],  $Q(6) = 7.792$ , and  $Q(12) = 18.096$ , and (2) ADF–GLS<sup>τ</sup> =  $-3.335^*$  [1],  $Q(6) = 6.596$  and  $Q(12) = 17.158$ .

Table 4  
Uncovered interest differentials

	Hong Kong/PRC	Taiwan/PRC	US/PRC	Japan/PRC
<i>A. Unit root test statistics</i>				
ADF–GLS <sup>μ</sup>	−2.126** [5]	−7.019** [1]	−1.698 [3]	−8.344** [1]
Q(6)	5.554	10.304	3.748	6.429
Q(12)	10.670	18.275	14.363	14.396
ADF–GLS <sup>τ</sup>	−2.808* [2]	−4.892** [2]	−1.263 [3]	−8.794** [1]
Q(6)	9.457	8.471	3.534	6.648
Q(12)	17.473	18.375	14.266	12.773
<i>B. Persistence</i>				
AR(1)	0.429*** (0.118)	0.189 (0.115)	0.384*** (0.115)	−0.022 (0.118)
AR(2)	0.137 (0.129)	—	0.268** (0.119)	—
AR(3)	0.070 (0.130)	—	0.270** (0.112)	—
AR(4)	−0.073 (0.129)	—	—	—
AR(5)	0.282** (0.115)	—	—	—
Adjusted R <sup>2</sup>	0.620	0.022	0.829	−0.013
<i>C. Trends in annual absolute averages</i>				
Individual	−0.950** (0.299)	−1.760 (2.448)	−1.005** (0.282)	−0.429 (1.902)
Group	−1.355 (1.292)			−0.717 (0.790)
Common		−1.036 (0.725)		

See notes in Table 3.

\* The sample mean is significantly different from zero at the 10% level.

\*\* Idem., 5%.

\*\*\* Idem., 1%.

counting for the 1997 crisis, all the uncovered interest differential series are stationary and shocks to uncovered interest parity are transitory.

The results of fitting the uncovered interest differential to Eq. (12) are given in panel B. The deviation from uncovered interest parity does not appear random for the Hong Kong/PRC and US/PRC pairs—the lagged uncovered interest differential variables are positively significant and indicative of strong persistence. The adjusted- $R^2$  are quite high at 62 and 83%, respectively. If monies are free to move across markets, arbitrage can generate profits based on the pattern of persistent deviation and help restore the parity. However, this kind of arbitrage activity is quite difficult, especially in the short run, given the prevailing capital controls in the PRC.

The Japan/PRC and Taiwan/PRC pairs display a different pattern. The lagged differentials are small and insignificant—indicating the deviations are quite random. Interestingly, these two differentials series have a variance that is 50 times to 125 times larger than those

of the Hong Kong/PRC and US/PRC series.<sup>20</sup> The extremely high volatility may make it difficult to uncover significant coefficients in the Japan/PRC and Taiwan/PRC regressions.

The annual absolute deviation from uncovered interest parity, which is constructed in the same manner as the absolute deviation from real interest parity (see Eq. (13)), is used to assess the trending behavior of uncovered interest disparity. While all the estimated common, group, and individual time trends have a negative sign—indicating the differentials are narrowing during the sample—only the estimates for the Hong Kong/PRC and US/PRC pairs are statistically significant. Again, the insignificant results are associated with the highly variable Japan/PRC and Taiwan/PRC series.

### 3.3. Relative purchasing power parity

The relative purchasing power differential series are used to assess goods market integration. The notion of relative purchasing power parity in (4) is different from the purchasing power parity commonly examined in the literature. First, the condition pertains to the growth rates—rather than levels—of the exchange rate and price variables. Second, in examining the evidence of serial correlation, this perspective on relative purchasing power parity draws on Roll's (1979) efficient market purchasing power parity hypothesis. Roll (1979) shows that, under the efficient market assumption, ex ante deviations from purchasing power parity are unpredictable. Frankel (1991), for example, suggests that violation of ex ante relative purchasing power parity is associated with incomplete integration of goods markets.

The empirical results are presented in Table 5. The ADF–GLS<sup>r</sup> and ADF–GLS<sup>μ</sup> tests strongly reject the presence of a unit root in these differential series. While the stationarity result is expected from the parity identity relationship and the results in the previous two subsections, it is reassuring to see the actual relative purchasing power differential series are stationary. Thus, there is evidence of long-run goods market integration between the PRC and other economies.

The results in panel B are quite different from the corresponding panels in the two preceding tables. The coefficient estimates of the lagged deviation from relative purchasing power parity are small and insignificant and the adjusted- $R^2$  are quite close to zero. If the information set is restricted to lagged relative purchasing power parity deviations,  $(\pi_{t,k} - \pi_{t,k}^* - \Delta s_{t,k})$  is a random series. The result is supportive of the Roll's (1979) efficient market purchasing power parity, which postulates  $\{\pi_{t,k}^e - \pi_{t,k}^{e*} - \Delta s_{t,k}^e\}$  is a zero mean random series.

There is no evidence of a decrease in the magnitude of relative purchasing power deviations revealed in panel C of Table 5. The results are based on fitting the annual averages of absolute differentials to Eq. (14). All three types of time trend (common, group, and individual) are not significant. Again, the results are in contrast with the corresponding ones in Tables 3 and 4, which report substantial evidence of diminishing deviation from the two

<sup>20</sup> During the sample period, Hong Kong and PRC have their currencies effectively pegged to the US dollar. Thus, the Hong Kong/PRC and US/PRC exchange rates are relatively stable and contribute little to the related uncovered interest differentials. On the other hand, the exchange rates of Taiwan and Japan vis-à-vis PRC are more volatile.

Table 5  
Deviations from relative purchasing power parity

	Hong Kong/PRC	Taiwan/PRC	US/PRC	Japan/PRC
<i>A. Unit root test statistics</i>				
ADF–GLS <sup>μ</sup>	−7.802** [1]	−7.568** [1]	−2.173** [4]	−3.291** [3]
Q(6)	10.144	4.479	1.126	3.897
Q(12)	14.180	17.802	18.415	12.809
ADF–GLS <sup>τ</sup>	−8.025** [1]	−4.069** [4]	−2.810* [6]	−8.602** [1]
Q(6)	7.455	0.868	0.421	5.737
Q(12)	9.574	15.862	17.863	13.984
<i>B. Persistence</i>				
AR(1)	0.094 (0.116)	0.115 (0.116)	0.123 (0.118)	−0.046 (0.120)
AR(2)	—	—	−0.209* (0.114)	−0.102 (0.121)
AR(3)	—	—	0.031 (0.116)	0.118 (0.121)
AR(4)	—	—	0.175 (0.116)	—
Adjusted R <sup>2</sup>	−0.004	−0.002	0.043	−0.013
<i>C. Trends in annual absolute averages</i>				
Individual	0.025 (0.160)	−1.199 (1.838)	0.264 (0.222)	0.775 (1.580)
Group		−0.586 (0.914)		0.519 (0.672)
Common			−0.033 (0.561)	

See notes in Table 3.

\* The sample mean is significantly different from zero at the 10% level.

\*\* Idem., 5%.

interest parities. Note, however, that the PRC opened its goods and services markets, albeit in a gradual fashion, long before launching financial reforms in the late 1990s. It is possible that the magnitude of relative purchasing power deviations declined before the current sample period and, hence, does not manifest itself in a declining trend in recent years.

To investigate the possibility that most of the process of goods market integration occurred before 1996, we extended the sample back to January 1984, thereby spanning the longest available exchange rate and price series. For the extended sample, the common trend estimate is  $-0.291$  (standard error = 1.122), the time trend estimate of the Hong Kong/PRC and Taiwan/PRC group is  $-0.722$  (standard error = 0.220), and the one of the Japan/PRC and US/PRC group is  $0.138$  (standard error = 2.257). For the individual time trends, only the Hong Kong/PRC estimate is statistically significant; the estimate is  $-1.037$  with standard error equal to 0.264. Thus, only the time trend estimates involving Hong Kong are significant and negative—indicating it is only the relative purchasing power gap between the PRC and Hong Kong that is declining during the period under investigation. The result is consistent with the fact that, among the four economies under consideration, Hong Kong has the longest “preferential” political and economic links with the PRC that

Table 6  
Summary of the parity conditions

	Hong Kong/PRC	Taiwan/PRC	US/PRC	Japan/PRC
<i>A. Real interest parity</i>				
Stationarity	yes	yes	yes	yes
Short-run persistence	yes	yes	yes	yes
Declining trend				
individual	no	no	no	yes
group				yes
common			yes	
<i>B. Uncovered interest parity</i>				
Stationarity	yes	yes	yes <sup>a</sup>	yes
Short-run persistence	yes	no	yes	no
Declining trend				
individual	yes	no	yes	no
group		no		no
common			no	
<i>C. Relative purchasing power parity</i>				
Stationarity	yes	yes	yes	yes
Short-run persistence	no	no	yes	no
Declining trend				
individual	yes <sup>a</sup>	no	no	no
group		yes <sup>a</sup>		no
common			no	

*Note.* The table summarizes the test results reported in Tables 3, 4, and 5. The rows labeled *Stationarity*, *Short-run persistence*, and *Declining trend* correspond to the *Unit root test statistics*, *Persistence*, and *Trends in absolute annual averages* presented in the preceding tables.

<sup>a</sup> The result allowing for the 1997 dummy variable as discussed in the text.

make Hong Kong better positioned to integrate with the PRC. Overall, results pertaining to the longer sample and those in Table 5 suggest that there is considerable evidence of goods market integration between the PRC and Hong Kong, and that much of it took place in the earlier period.

The results of testing the parity conditions are summarized in Table 6. All in all, there is evidence that the three parity conditions hold in the long run. The unit root null is rejected for all the series and, thus, the deviations from these parity conditions are stationary. Given the short sample considered and the usual concern about the power of unit root tests, the evidence of the three long-run parity conditions is quite strong. While the results are supportive of the validity of long-run parity conditions, there are substantial signs that these parities do not hold in the short run. There is also some evidence that some economy-pairs experience a decline in the magnitude of some disparities.

Apparently, the PRC and Hong Kong have the highest level of integration. The finding is not terribly surprising given the close ties between these two economies that developed well before the PRC embarked upon its program of economic reform. On the other hand, Taiwan, compared with Japan and the US, does not appear to be more integrated with the PRC. Thus, discussion of an economically integrated Greater China entity should be nuanced.

#### 4. The economic determinants of parity deviations

To this point, we have discussed the time series behavior of deviations from these three parity conditions. One drawback of the pure time series approach is that we are unable to determine whether the decline in the size of the differentials (when it occurs) is due to increasing integration, or due to convergence in macroeconomic policies. For instance, if uncovered interest parity does not hold perfectly, then in principle, monetary policies can exert an influence on the *ex ante* and *ex post* deviation from uncovered interest parity.<sup>21</sup>

##### 4.1. A regression equation

In order to ascertain whether the deviations from parity conditions are a function of the reduction in trade barriers and financial restrictions, we undertake a panel regression analysis. We posit that financial account restrictions will impede capital flows, thereby allowing greater scope for deviations from uncovered interest parity. To proxy the degree of financial account restrictions, we employ the capital control index compiled by Chan-Lee (2002) for the Asian Development Bank. The index is denoted by  $KAOPEN_{j,t}$ —a large index value means a low level of capital controls.

Similarly, we anticipate greater trade barriers would be correlated with greater deviations from purchasing power parity. Unfortunately, we do not possess good information on the extent of trade barriers. Many of the existing estimates pertain to points in time. Consequently, we use trade intensity as a proxy for the amount of arbitrage activity and assume it is negatively related to trade barriers. More specifically, we adopt:

$$TRADE_{j,t} = (X_{PRC,j,t} + M_{PRC,j,t}) / (X_{j,t} + M_{j,t} + X_{PRC,t} + M_{PRC,t}) \quad (15)$$

where  $X_{PRC,j,t}$  ( $M_{PRC,j,t}$ ) is the PRC's export to (import from) economy  $j$ ,  $X_{j,t}$  ( $M_{j,t}$ ) is  $j$ 's total export (import), and  $X_{PRC,t}$  ( $M_{PRC,t}$ ) is the PRC's total export (import), all at time  $t$ .<sup>22</sup>

The factor endowment theory of international trade predicts the convergence of product prices across economies; either free movement of goods or that of production factors can enhance, for example, goods market integration. Thus, foreign direct investment (FDI) that induces factor movements can affect how well the parity condition holds.<sup>23</sup> For this reason, we include FDI in the exercise and, specifically, anticipate that a strong FDI link leads to a small relative purchasing power deviation. The variable  $FDI_{j,t}$ —the economy  $j$ 's FDI flow to the PRC in period  $t$  normalized by the PRC's gross domestic product is used to measure the FDI effect.

The other two variables reflect in part macroeconomic policies. The first is the volatility of *ex post* exchange rate changes; the second the volatility of relative inflation. The

<sup>21</sup> See for instance Willett et al. (2002).

<sup>22</sup> The measure has been used in empirical studies of the gravity models of international trade. See for instance Frankel and Rose (1998).

<sup>23</sup> In other words, FDI is considered as a substitute for goods trade and, hence, induces relative price convergence between economies. See, for example, Goldberg and Klein (1998, 1999) for empirical evidence.

definitions of the differential series offer a clue to the effect of exchange rate movements. Exchange rates are notoriously difficult to forecast. A priori, one would expect that greater deviations from ex post uncovered interest parity occur with greater exchange rate volatility. One possibility is that high ex post exchange rate volatility occurs with large expectation errors, which affect ex post uncovered interest parity deviations. Also, exchange rate volatility can influence relative purchasing power parity deviations—exchange rate volatility coupled with sticky prices are deemed to be a reason why the purchasing power parity does not hold.

Inflation is difficult to predict and affects nominal interest rates. We hypothesize that relative inflation variability can influence uncovered interest differentials via the nominal interest differential and relative purchasing power parity deviations via the relative inflation term. We use 13-month centered moving variances as proxies of the volatilities of exchange rate changes and relative inflation. The proxies are denoted by  $MVS_{j,t}$  and  $MVP_{j,t}$ , respectively.

For each of three differential series, we pool the data across the four economy-pairs and estimate

$$ADEV_{j,t} = c + \delta_1 KAOPEN_{j,t} + \delta_2 \ln TRADE_{j,t} + \delta_3 \ln FDI_{j,t} + \delta_4 MVS_{j,t} + \delta_5 MVP_{j,t} + u_{j,t} \quad (16)$$

where  $ADEV_{j,t}$  is the absolute deviation from a given parity,  $c$  is a constant,  $u_{j,t}$  is the disturbance term, and the other variables are proxy variables described above.

#### 4.2. Empirical results

The estimation results are summarized in Table 7. The selected economic variables explain absolute uncovered interest and relative purchasing power parity differentials quite well but not absolute real interest differentials. These variables account for only 2.4% of absolute real interest differential variation but over 30% of variations in the other two series. Indeed, none of the economic variables is significant in the absolute real interest differential regression.

The capital control index  $KAOPEN_{j,t}$  has the expected negative effect on all three absolute differential series. However, only the two coefficients of the absolute uncovered interest and relative purchasing power parity differential equations are statistically significant. It is not too surprising to observe significant capital control effect on deviations from relative purchasing power parity as capital controls usually accompany trade impediments. The regression results confirm that a low level of capital controls facilitates integration.<sup>24</sup>

The effect of the variable  $TRADE_{j,t}$  is difficult to interpret. Specifically, this variable has an unexpected positive effect on the three differential series. While the trade variable is insignificant in two series, it is significant for absolute relative purchasing power parity

<sup>24</sup> Note that statistical significance is evaluated using robust standard errors. The least absolute deviation (LAD) approach was also used to assess the capital control effect. Under LAD,  $KAOPEN$  has a significant negative effect on absolute real interest differentials though there was no improvement in the adjusted- $R^2$ .

Table 7  
Panel regression results on the absolute deviations from the parity conditions

	Dependent variable		
	Absolute real interest differentials	Absolute uncovered interest differentials	Absolute relative purchasing power differentials
$KAOPEN_{j,t}$	-1.062 (1.267)	-6.378* (3.283)	-6.579** (3.242)
$TRADE_{j,t}$	0.496 (0.815)	5.718 (3.928)	7.988** (3.854)
$FDI_{j,t}$	0.709 (0.480)	-3.046* (1.553)	-3.363** (1.492)
$MVS_{j,t}$	0.000 (0.000)	0.013*** (0.002)	0.011*** (0.002)
$MVP_{j,t}$	0.020 (0.022)	-0.008 (0.027)	0.050 (0.031)
Constant	15.533 (7.948)	30.555 (20.218)	36.198 (20.225)
Adjusted $R^2$	0.024	0.368	0.331

Notes. Absolute deviations from real interest parity, uncovered interest parity, and relative purchasing power parity are regressed on the variables listed in the first column using panel data with  $j =$  Hong Kong, Taiwan, the US, and Japan (Eq. (16)). Heteroskedastic-consistent standard errors are provided in the parentheses.

\* The sample mean is significantly different from zero at the 10% level.

\*\* Idem., 5%.

\*\*\* Idem., 1%.

differentials. We do not have an explanation for the results. Other measures of trade intensity were also explored but did not change the results. Interestingly, Campa and Wolf (1997) also find a similar trade variable to have a positive effect on purchasing power parity differentials. In our context, the trade variable may not be a good proxy for (the absence) of trade barriers.

The effects of the FDI and exchange rate volatility variables,  $FDI_{j,t}$  and  $MVS_{j,t}$ , are significant and with the expected signs for absolute uncovered interest and absolute relative purchasing power parity differentials but are statistically insignificant for absolute real interest differentials. The significant FDI effect is negative; indicating small disparity is associated with a high level of FDI. FDI flows facilitate movements of financial and physical capitals and, thus, narrow gaps in uncovered interest and relative purchasing power parities. On the other hand, the significant exchange rate volatility effect is positive—a result in accordance with the assertion that high ex post exchange rate volatility can lead to large uncovered interest and relative purchasing power differentials.

Unlike exchange rate volatility, the other policy variable—relative inflation volatility,  $MVP_{j,t}$ , has very limited effect on the differential series under investigation. Indeed, for all the three differential series, the estimates of the  $MVP_{j,t}$  coefficient are both small and statistically insignificant. Since the exchange rate is more volatile than inflation, the relatively low variability of inflation may contribute to the lack of significant results.

Overall, the ability of the selected economic variables to explain the behavior of deviations from parities is mixed.<sup>25</sup> While they explain about one third of the variations in absolute uncovered interest and absolute relative purchasing power parity differentials, they offer little help in explaining movements in absolute real interest differentials. The capital controls, FDI, and exchange rate volatility variables have the expected sign when they are significant. The trade variable tends to have the wrong sign and the relative inflation variance variable is not significant. Given the exploratory nature of the exercise, the results are encouraging.

## 5. Concluding remarks

The integration of the PRC into the world economy has preoccupied business leaders and policy makers alike. There is a plethora of evidence that flows of capital and goods to and from the PRC are increasing. This study has undertaken a price-based (prices of goods, prices of assets) assessment of the degree of integration. We consider three parity conditions, based on economic theory. They include real interest parity as an indicator of “real” capital mobility, uncovered interest parities for assessing financial capital mobility, and deviations from relative purchasing power parity for measuring goods market integration. We find, to varying degrees, that the long-run version of the three parity conditions hold between the PRC and the other Greater China economies as well as its major trading partner—Japan and the US. On the other hand, the data do not in general satisfy the short-run parity conditions and we can conclude that the markets are not completely efficient.

In comparing the levels of integration between the PRC and the two other Greater China economies (Hong Kong and Taiwan) and the two other non-Greater China economies (Japan and the US), there is no substantial evidence that the integration among the Greater China economies is stronger than that between the PRC and the non-Greater China economies. In general, Hong Kong appears to have an advanced level of integration with the PRC. On the other hand, the PRC’s link with Taiwan, another Greater China economy, is not stronger than those with Japan and the US. The differential results from Hong Kong and Taiwan suggests that, during the sample period, integration with the PRC is not necessarily an intrinsic characteristic of a Greater China economy. In addition, we find that the exchange rate regime choice has substantial implications for the results on integration. A *de facto* fixed exchange rate arrangement is associated with strong evidence of integration while weak integration tends to occur with a flexible rate arrangement.

Even though the statistical results offer some evidence of integration, we recognize that there are non-negligible restrictions on both physical and financial flows between the PRC and other economies. Recent developments are, however, promising. For instance, its recent efforts to promote trade with other East Asian economies and scheduled removal

---

<sup>25</sup> We also considered samples consist of observations from only Hong Kong/PRC and Taiwan/PRC and from only Japan/PRC and US/PRC. The regression results are qualitatively the same as those reported.

of barriers associated with joining the WTO suggest that the PRC economy will be increasingly integrated with the other economies. The increasing interactions between the PRC and the rest of the world will make the costs associated with the remaining impediments to integration more obvious and costly. Hence, we envision this process of integration continuing, and to the extent that this process requires even more political engagement, we believe the prospects for cooperation along a variety of dimensions are good.

One interesting aspect of this study is that we not only find increasing convergence in the three parities, we also empirically identify a few regulatory and economic policy factors that determine the extent of integration. Specifically, proxies for capital controls, trade intensity, FDI, and exchange rate volatility are found to be significant factors though the trade intensity variable has the wrong sign. The results are quite positive given the exiguity of quality data on these regulatory and administrative variables. Nonetheless, we believe that additional analyses using different criteria of integration and alternative measures of regulatory and economic policy factors can offer valuable and complementary insights on integration between the PRC and other economies.<sup>26</sup>

We also confirm results found elsewhere in the international finance literature—namely that the extent of the deviations from parity conditions depends upon the currency regime. When the exchange rate is effectively pegged, then the variability of the shocks to relative purchasing power parity are on the same order as those to real interest parity. In contrast, when exchange rates are (managed) floating, the shocks to relative purchasing power parity are on the same order as those to uncovered interest parity. This suggests that the size of the relative purchasing power parity perturbations is a function of the exchange rate regime the PRC has maintained since 1994. As the PRC moves toward currency convertibility, it is likely that over the intermediate run, some form of managed float will likely be implemented. The variability of the deviations from relative PPP, and hence real interest parity, will likely depend on how the PRC manages its macroeconomy, and in particular, how it deals with the contingent liabilities of the banking sector and the pension system.

## Acknowledgments

We thank Editor John Ries, two anonymous referees, Yunjong Wang, and seminar participants at the Institute for Monetary and Economic Studies of the Bank of Japan and at the Claremont China Conference for helpful comments and suggestions. The financial support of faculty research funds of the University of California, Santa Cruz is gratefully acknowledged. The views contained herein are solely those of the authors, and do not necessarily represent those of the institutions they are associated with.

---

<sup>26</sup> The concept of integration is difficult to define and measure precisely. Other approaches to assessing integration include (a) measuring the trade linkages, (b) comparing the expected yields on similar assets in different economies, and (c) evaluating the correlation of (output) shocks across economies and the relative contributions of common and economy-specific shocks to output variations. It is our belief that these approaches can offer valuable and complementary insights on the degree of integration between the PRC and other economies.

## Appendix A

The interest rate and price data are collected from four sources—Bloomberg Financial Services, CEIC database, International Financial Statistics, and the Hong Kong Monetary Authority. The monthly series retrieved from Bloomberg is the PRC one-month interbank offer rate. The monthly series retrieved from CEIC are the Hong Kong one-month interbank offer rate, the Taiwan one-month interbank offer rate, the Taiwan–US exchange rate, the Hong Kong consumer price index, and the Taiwan consumer price index. The Taiwan interest rate is the middle rate given by a simple average of the high and low rates. The monthly series from International Financial Statistics are dollar-based exchange rates of Hong Kong dollar and China yuan. The Hong Kong Monetary Authority provided the PRC consumer price series.

The sample period is from February 1996 to June 2002. The X-12 routine (with multiplicative factors on the levels) was used to seasonally adjust all the price series. The Japanese CPI series also had an adjustment for the imposition of new taxes in April 1997.

In Section 4, the capital control data were obtained from James Chan-Lee, and are described in Chan-Lee (2002). These indices were tabulated using the criteria and methodology of Quinn (1997); the recorded degree of restrictiveness is based on a reading of the regulations in place. Higher values indicate less restrictiveness. Values for 2001 were assumed to equal the 2000 values for all cases except Taiwan, which uses the preliminary value assigned. In constructing the trade variable, the data on imports and exports are extracted from the Direction of Trade Statistics for all economies but Taiwan. The Taiwan data are provided by the Board of Foreign Trade of Taiwan at their website. The FDI data are obtained from the CEIC database. The 13-month centered moving variances of exchange rate changes and inflations rates are calculated using the consumer price and exchange rate data described above.

## References

- Campa, J.M., Wolf, H.C., 1997. Is real exchange rate mean reversion caused by arbitrage? Working paper No. 6162. NBER.
- Chan-Lee, J., 2002. Beyond sequencing: what does a risk-based analysis of core institutions, domestic financial and capital account liberalization reveal about systemic risk in Asian Emerging Market Economies? Research paper No. 46. Asian Development Bank Institute, Tokyo.
- Cheung, Y.-W., Lai, K.S., 1995. Lag order and critical values of a modified Dickey–Fuller test. *Oxford Bull. Econ. Stat.* 57, 411–419.
- Cheung, Y.-W., Chinn, M.D., Fujii, E., 2003. China, Hong Kong and Taiwan: Real and financial integration. *China Econ. Rev.* 14, 281–303.
- Chinn, M.D., Frankel, J.A., 1994. Financial links around the Pacific rim: 1982–1992. In: Glick, R., Hutchison, M. (Eds.), *Exchange Rate Policy and Interdependence: Perspective from the Pacific Basin*. Cambridge Univ. Press, Cambridge, pp. 17–26.
- Cumby, R.E., Mishkin, F.S., 1986. The international linkage of real interest rates: the European–US connection. *J. Int. Money Finance* 5, 5–23.
- Cumby, R.E., Obstfeld, M., 1984. International interest rate and price level linkages under flexible exchange rates: a review of recent evidence. In: Bilson, J.F.O., Marston, R.C. (Eds.), *Exchange Rate Theory and Practice*. Univ. of Chicago Press, Chicago, pp. 121–151.

- Elliott, G., Rothenberg, T.J., Stock, J.H., 1996. Efficient tests for an autoregressive unit root. *Econometrica* 64, 813–836.
- Engel, C., Rogers, J.H., 1996. How wide is the border? *Amer. Econ. Rev.* 86, 1112–1125.
- Fernald, J., Edison, H., Loungani, P., 1999. Was China the first domino? Assessing links between China and other Asian economies. *J. Int. Money Finance* 18, 515–535.
- Frankel, J.A., 1991. Quantifying international capital mobility. In: Bernheim, D., Shoven, J. (Eds.), *National Saving and Economic Performance*. Univ. of Chicago Press, Chicago, pp. 227–260.
- Frankel, J.A., Froot, K.A., 1997. Using survey data to test standard propositions regarding exchange rate expectations. *Amer. Econ. Rev.* 77, 133–153.
- Frankel, J.A., Rose, A.K., 1998. The endogeneity of the optimum currency area criteria. *Economic J.* 108, 1009–1025.
- Goldberg, L.S., Klein, M.W., 1998. Foreign direct investment, trade and real exchange rate linkages in developing countries. In: Glick, R. (Ed.), *Managing Capital Flows and Exchange Rates: Perspectives from the Pacific Basin*. Cambridge Univ. Press, Cambridge, pp. 73–100.
- Goldberg, L.S., Klein, M.W., 1999. International trade and factor mobility: an empirical investigation. Working paper No. 7196. NBER.
- Ha, J., Fan, K., 2002. Price convergence between Hong Kong and the Mainland. Research memorandum. Hong Kong Monetary Authority, Hong Kong.
- Harding, H., 1995. The concept of ‘Greater China’: themes, variations and reservations. In: Shambaugh, D. (Ed.), *Greater China: The Next Superpower?* Clarendon, Oxford, pp. 8–34.
- Li, Y., Peng, X., 2002. The money market in China: theory and practice. *China World Economy* 10, 3–10.
- Ma, J., 2001. Quantifying the effect of China’s WTO entry. Global markets research. DeutscheBank, Hong Kong.
- Mark, N., 1985. Some evidence on the international inequality of real interest rates. *J. Int. Money Finance* 4, 189–208.
- Mishkin, F.S., 1984. Are real interest rates equal across countries? An empirical investigation of international parity conditions. *J. Finance* 39, 1345–1357.
- Naughton, B. (Ed.), 1997. *China Circle: Economics and Technology in the PRC, Taiwan, and Hong Kong*. Brookings Institution, Washington, DC.
- Noland, M., Liu, L.G., Robinson, S., Wang, Z., 1998. Global economic effects of the Asian currency devaluations. Policy analyses in international economics 56. Institute for International Economics. Washington, DC.
- Parsley, D.C., Wei, S.-J., 2001. Explaining the border effect: The role of exchange rate variability, shipping cost, and geography. *J. Int. Econ.* 55, 87–105.
- Prasad, E. (Ed.), 2004. *China’s Growth and Integration into the World Economy: Prospects and Challenges*. IMF, Washington, DC. Also: Occasional paper No. 232.
- Quinn, D., 1997. The correlates of change in international financial regulation. *Amer. Polit. Sci. Rev.* 91, 531–551.
- Roll, R., 1979. Violations of purchasing power parity and their implications for efficient international commodity markets. In: Sarnat, M., Szego, G.P. (Eds.), *International Finance and Trade*. Ballinger Publishing, Cambridge, pp. 133–176.
- Shellekens, P., 2002. Deflation in Hong Kong, SAR, People’s Republic of China—Hong Kong special administrative region: selected issues. Country report 02/99. IMF, Washington, DC.
- The Economist Intelligence Unit, 2003. *China*. Country report. The Economist Intelligence Unit, London. March.
- Wang, Z., 2001. The impact of China’s WTO accession on patterns of world trade. Paper presented at ASSA Annual Meeting in Atlanta, GA, January 4–6, 2002.
- Wei, S.-J., Frankel, J.A., 1994. A ‘Greater China’ trade bloc? *China Econ. Rev.* 5, 179–190.
- Wei, S.-J., Liu, L.G., Wang, Z., Woo, W.T., 2000. The China money puzzle: Will devaluation of the Yuan help or hurt the Hong Kong Dollar? *China Econ. Rev.* 11, 171–188.
- Willett, T.D., Keil, M.W., Ahn, Y.-S., 2002. Capital mobility for developing countries may not be so high. *J. Devel. Econ.* 68, 421–434.
- Xie, D., 2002. Analysis of the development of China’s money market. *China World Economy* 10, 29–37.