High-level policy panel on the development of financial markets

Joseph Yam[1]

As I was thinking about what to say at this high level policy panel, against the background of the financial crisis we are experiencing, I kept feeling that there was a need for finance to go back to basics, or at least for everybody to be reminded of them. I recalled something that I wrote in August 2006, in which I said: “Finance is not a mysterious or esoteric subject, but it often misunderstood. As prices of financial instruments go sharply up and down, and the opportunity for profit multiplied through leverage and the use of derivative products, mesmerises all concerned and provides employment and income for many, the basic purpose of finance is often ignored or even forgotten. There is then a risk of finance taking on a life of its own, behaving in a manner inconsistent with the public interest. It is necessary from time to time for all concerned in finance to be reminded of the basic purpose of their existence.”

This is the beginning of an article I wrote entitled “A Basic Law of Finance”. There are 13 or 14 articles in that Basic Law and one of them states that: “The private interests of financial intermediaries, who are understandably motivated by profit, are not necessarily aligned with the public interest of effective financial intermediation. Where there is conflict, it is the role of financial regulation and supervision to ensure that the public interest is protected.”

In yet another article that I wrote, entitled “The Alphabet Soup”, I questioned the role that such financial derivatives as CDO, CDS, ABCP and SIV were playing in promoting the efficiency of financial intermediation that is so important for supporting the economy. Furthermore, when confronted with the bowl of thick alphabet soup, one finds it very difficult to see the bottom of it and, when one eventually reaches the bottom, one has probably consumed too much of it.

There is indeed a need for finance to go back to basics. Finance is about financial intermediation, or the matching of the needs of those with surplus money with those in need of it. This is the role of the financial system and it is for the authorities, through conduct regulation and supervision of the financial intermediaries, to ensure that financial intermediation is conducted with a high degree of stability, integrity, diversity and efficiency. There is also a need for the authorities to be involved in the provision of a safety net, in crisis resolution and in the development of the financial infrastructure, which is very much a public good, the provision of which cannot be relied upon when left to the initiative of the private sector.

Let me, in this connection, share with you a few observations that I have accumulated over the years as head of the Hong Kong Monetary Authority. First is the conflict between the private interests of the financial intermediaries and the public interest of promoting effective financial intermediation. The financial intermediaries, be they in the form of banks or securities houses, actually have an interest in financial inefficiency. They would like the intermediation spread, their take so to speak, to be as wide as possible; but then the wider the intermediation spread the less efficient is financial intermediation. Often financial intermediaries, presumably because they control where the money comes from and where it goes to, have very strong political influence, to the extent of being able to dictate the reform

[1] Chief Executive of the Hong Kong Monetary Authority

agenda for the financial system and make sure that reform measures are promulgated without undermining too much their private interests as financial intermediaries. The authorities should have a response to this phenomenon.

The second observation is the dilemma of financial openness. Financial openness is of course good in that, in accepting international mobility of capital, domestic capital can achieve a higher risk-adjusted rate of return, and domestic borrowers can enjoy diversity of funding sources. But openness often comes with risks to financial stability that are difficult to manage, which brings me to my third observation concerning the relationship between size and vulnerability. I have found that medium-sized markets are the most vulnerable. While there is enough liquidity to attract international capital, their size is small relative to the volume of international capital that is being mobilised by the profit motive, often without regard to financial stability. They are therefore most vulnerable to the volatility of international capital, not to mention the predatory character that it takes on from time to time.

My third observation is that financial markets do fail. No matter how efficient they are, when greed and fear take hold, the risk of failure is there, and this occurs all too often. Very simply, the authorities have a responsibility to take decisive action to prevent failure from occurring or to put things back on track. Market interventions of one type or another are needed in the light of circumstances and such intervention should not be blindly condemned as wrong. Hong Kong had its unfair share of criticisms in its market intervention in 1998, but the action is of the same nature as the massive intervention in the developed markets in the current crisis.

My last observation is that there are elements of the financial infrastructure that are simply public goods, the provision of which by the public sector is well justified, even though there is a lot of resistance from the private sector, particularly the financial intermediaries having an interest in sustaining financial inefficiency for their own benefit. Governments spend large sums of money building the physical infrastructure to move people from one place to another safely and efficiently in support of the economic activity they are engaged in. But they do not spend quite enough to make sure that money is moved around from one holder to another with the same safety and efficiency.

I should apologise for not having a formal presentation for you. Running the monetary authority of an international financial centre at a time of global financial crisis is demanding enough, but I also have another job which is to prepare for retirement after sixteen and a half year as head of the Hong Kong Monetary Authority. I hope, nevertheless, that my observations are useful.

Let me now pass over to Grant Spencer.