Joseph Yam: Developing and positioning Hong Kong's bond market

Speech by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Forum on China's Government Securities Market in the New Century, Hong Kong, 19 November 2001.

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Introduction

It is a great pleasure for me to be here today to share with you Hong Kong's experience in the development of the bond market and our views on the future prospects of that market. Before I go into the subject, however, I would like to congratulate our friends from the Mainland on their superb efforts leading to China's accession to the World Trade Organisation. The signing of the necessary documents a week or so ago marks the successful conclusion of 15 years of sheer hard work and determination, and the beginning of a new era in which the Mainland embraces globalisation in earnest, to the long-term benefit of China, the region and the world. I have no doubt that Hong Kong, in particular, will benefit tremendously from this. The international business community has been positioning itself, here in Hong Kong a free and open economy at the doorstep of the Mainland and an integral part of China to take advantage of the many opportunities that will open up in the years to come. As the international financial centre of China, Hong Kong is particularly looking forward to the opportunities arising from a much quicker pace of financial liberalisation in the Mainland after accession to WTO. Put simply, notwithstanding the gloom of global recession, the future of Hong Kong is bright.

Bond market development

Let me turn quickly now to bond market development. There are a few points that I would like to make immediately. The **first** point is a basic and obvious one, so obvious that it is often overlooked. This is that the bond market is a channel of financial intermediation for the purpose of mobilising savings into productive investment that promotes economic growth and development. There is a need for those involved in the bond market those responsible for its development and those making a profit or a living from it to be frequently reminded of this basic purpose. This is particularly so when considering the introduction of sophisticated products derivatives and the like. I have nothing against sophisticated financial engineering, or against the engineers being well remunerated, provided that the regulators and the market participants, both at the wholesale and retail levels, are capable of appreciating and coping with the associated risks. This may not often be the case. It is possible that, while these products theoretically make the market more efficient, in terms of spreading and managing risks, in practice the risks may be magnified, to the extent of creating systemic instability and disrupting the crucial flow of funds through that basic and important channel of financial intermediation.

The **second**, again rather obvious, point is that the bond market is one of three broad channels of financial intermediation, along with the better developed, at least in this region, banking and equity markets. Less obvious, perhaps, is the importance of ensuring that the bond market commands a degree of robustness and efficiency capable of channelling suddenly enlarged flows of savings to investment that may be diverted from one or both of the other two channels as a result of crises there. These channels should reinforce each other in order that financial intermediation and therefore economic growth can continue in times of financial stress. We have witnessed how the US bond market helped substitute for bank intermediation in the credit crunch of the late eighties. We have also witnessed how the US banking system in turn played the back-up role when the bond market failed to intermediate funds as a result of the LTCM crisis, thus minimising the disruption to economic growth. In contrast, the less developed bond market in this region failed to provide the necessary backup when banks in a number of jurisdictions faced difficulties. Funds simply dried up and there were debilitating economic and financial consequences. Bond market development in this region is thus an urgent task.

This task is, however, hindered by a **third** point, which is that the three channels of financial intermediation are in competition with each other. This is so to the extent that the development of the bond market, at least in this region, may have been inhibited by the rather more efficient banking and equity markets. Understandably, vested interests may have exerted a degree of influence to this effect, and this is one reason why the bond market, where it is underdeveloped, may have to be considered as a public good that justifies the involvement of the official sector in its development. This is indeed the case in Hong Kong, but it has come about only after a long period of agonising over whether such deliberate government involvement, in the freest economy in the world and without a continuing need for government borrowing to finance budget deficits, was appropriate. Perhaps with greater institutional integration in the provision of financial services, the lack of enthusiastic support in the development of the bond market from service providers in the alternative channels of financial intermediation will in time be transformed into co-operation or even initiative, thus obviating the need for government involvement. In the meantime, however, and having regard to the degree of financial sophistication of most economies in the region, some official sector involvement in bond market development seems justified. This might be in the form of facilitating development of the market infrastructure, ironing out administrative obstacles, helping with education, etc, rather than more direct or obvious forms of subsidy.

Fourth, bond market financial intermediation need not be narrowly confined to just a domestic phenomenon. It can and should take on an international dimension. Through facilitating the inward investment of foreign savings, the source of funding for much needed domestic investments can be tremendously enlarged. This would also enhance the overall efficiency in the international allocation of funds, to economies that can provide a higher return commensurate with the risks involved. An economy with capital controls should therefore plan for the eventual internationalisation of the bond market, even though the associated financial liberalisation process can be quite a risky one. But risks are to be managed and not avoided, and the benefits of open markets far outweigh the costs in terms of financial instability. I can confirm this, even with the unpleasant experience of the financial turmoil of 1998. Free and open markets impose a valuable discipline on policy makers that is to be welcomed in the long-term interest of the people they serve.

Fifth, and turning to the actual bond market development issues, there is a need to adopt a comprehensive approach. We should address the demand and supply sides, the environment in which they interact to discover the prices for the debt instruments, including market making arrangements and the determination of benchmarks, and the market infrastructure, including payment, clearing and settlement systems.

Focusing on these issues individually, and this is the **sixth** point, there is usually strong latent demand for debt instruments, particularly in economies with a high savings rate. Between the low risk-return bank deposits and the high risk-return equity market, there should be a risk-return profile that fits that of debt instruments. The trick is how this latent demand, involuntarily trapped at the two ends of the spectrum, can be brought out and satisfied. Investor education and the creation of a retail network to market debt will help. But the costs of the latter can be quite substantial and possibly prohibitive, particularly in a low interest environment, if the retail banking system cannot be relied upon to support this wholeheartedly (which I am glad to add is not the case in Hong Kong). Furthermore, when government debt is used by the banking system as assets for acquiring liquidity support, the demand from the banks may easily crowd out the retail demand. Nevertheless, the institutionalisation of savings, if this could be organised, through for example the introduction of professionally managed provident fund schemes, should be quite effective in harnessing this demand. This would, at the same time, enable the retail demand to be transformed into a level of sophistication that, with the appropriate supply response, will greatly enhance the efficiency and robustness of the debt market as a channel of financial intermediation.

The **seventh** point I wish to make concerns the supply side. For an economy with a continuing need to finance budget deficits there is of course a natural supply of debt instruments, unless, like Hong Kong, it has surpluses to spend. But the story does not end there. It is essential for this supply of government debt to be organised in such a way as to enable demands of different natures to be met. This requires a well structured, transparent and predictable programme, with a wide maturity spectrum.

Thus, my **eighth** point concerns the interaction of demand and supply to discover price reliably and efficiently. This is relevant to both the primary and the secondary markets, and is best achieved respectively through well-structured tender and market making arrangements. These may involve last resort support from the regulators. There are many successful models of such arrangements and there is ample literature on them. The common objective is to ensure a high level of liquidity to facilitate reliable and efficient price discovery, thereby providing a benchmark yield curve upon which other issuers can confidently and accurately price their own, hopefully much bigger volume of, private sector debt. That is what we should aim for in the development of the bond market if it is to play a meaningful role in financial intermediation.

My **ninth** point concerns the market infrastructure, and by that I mean the payment, clearing and settlement systems. This is regrettably the most neglected aspect in the development of financial markets, not just the bond market. Imagine how general investor confidence would be damaged if the financial instrument that an investor had bought got lost in delivery. Or if he had to wait a considerable amount of time to receive it after he had paid over the money, or if the money that he had paid over was not received by the vendor. I have often pointed out that governments spend huge amounts of money and efforts building the physical infrastructure to move people and goods around safely and efficiently, but that not even a small fraction of those resources is given to moving money and financial instruments around safely and efficiently. The result, very simply, is inefficient financial intermediation. Money is not mobilised to its full potential, and economic progress is undermined. The financial infrastructure that we want, to use a bit of market jargon, is one that enables, as soon as possible after dealing, RTGS DvP, namely, real time gross settlement with delivery versus payment for transactions in financial instruments (RTGS PvP or payment versus payment for foreign exchange transactions). This is what we have achieved in Hong Kong.

Hong Kong's bond market

Let me turn now to the development of Hong Kong's bond market and share with you our experience. As I said earlier, after agonising over this for a long period, behind the convenient argument that if there is a need for a market to develop it will develop by itself without the urging of government, we decided to get involved. The Exchange Fund Bills and Notes programme was subsequently introduced at the beginning of 1990. But the primary justification deployed then was the need for a money market instrument, targeted at the banks as customers, to facilitate monetary management rather than the development of the bond market. Nevertheless, we adopted a comprehensive approach to the task. We put together an innovative market making system that virtually guaranteed liquidity by allowing a handful of market makers to go short in any issue of our paper for as long as their overall holdings, with suitable haircuts, are long. This has now been replaced by an even more robust arrangement whereby short positions in particular issues are squared at the end of the day through overnight repos against other issues. We also built a paperless clearing, settlement and custodian system operated by our Central MoneyMarkets Unit (CMU), which also provided similar services to the larger volume of private sector debt. And, at the same time as we introduced our Real Time Gross Settlement payment system at the end of 1996, we moved on to DvP, or delivery versus payment, with real time and end of day capabilities.

Meanwhile, the supply of debt has steadily been increasing. Corporate bond issuance has increased by 300 per cent in the last decade or so. We also have an increasing variety of products, including mortgage-backed securities and retail products brought to the market by the Hong Kong Mortgage Corporation. All have been readily absorbed by the latent demand to which I also referred earlier. And with the recent introduction of the Mandatory Provident Fund schemes, the demand for bonds has been building up quickly. In 1991, the bond market has a size of only about 4 per cent of GDP. This has grown to 35 per cent last year, and the share of private sector debt is now at around 77 per cent. We have come a long way but there is still a lot of room for expansion, as evidenced by comparisons with bond markets in the G-3 economies. But our bond market has grown big enough and has been robust enough for it to provide some meaningful back-up in times of financial stress. In 1998-99 when, as property prices fell sharply and the financial turmoil led to deteriorating asset quality, the banks adopted a conservative stance in their lending, corporate bond issuance increased significantly.

Positioning for the future

Our present pre-occupation in the development of the Hong Kong bond market is to bring in the international dimension. As an international financial centre, we of course aspire to play a role in international financial intermediation. To achieve this, our efforts have been concentrating on two fronts. First is the establishment of bilateral linkages of the appropriate elements of our financial infrastructure with those of other jurisdictions wherever it is compatible to do so, and whenever the counterparts are willing. This basically is for the purpose of facilitating the cross border investments in debt securities. Our CMU was linked up with Euroclear and Clearstream in 1994, with the Central Securities Depositories in Australia in 1997, New Zealand in 1998 and Korea in 1999. We also have a standing offer in the region to link up our Hong Kong dollar RTGS payment system with other currencies with RTGS capability so as to achieve payment versus payment in foreign exchange transactions, in other words, to eliminate Herstatt risk. But I must confess that, for the former, there has not been a lot of traffic, and for the latter, there have been no takers, so far. I hope this is merely a reflection of the fact that the financial infrastructures of others are not yet ready for these types of linkages. But I really cannot see a more robust arrangement than what we have proposed for promoting and facilitating the international financial intermediation that is found so lacking in the region. But we shall be patient.

The other front that we have been working on is the replication of our Hong Kong dollar financial infrastructure for the US dollar, the popular currency for international financial intermediation. We have late last year completed this for the debt clearing system and the RTGS payment system. We have linked these to the corresponding systems in the Hong Kong dollar financial infrastructure. I won't bore you with the technical details. What this means is that we now have, in this time zone, a robust financial infrastructure for US dollar transactions that can accommodate, among other things, a US dollar bond market in this region. You do not have to wait until New York opens before you can achieve finality of settlement of your US dollar transactions in bonds or, indeed, in any US dollar denominated financial assets, if they are lodged with our CMU in Hong Kong. Furthermore, any Asian currency with an RTGS payment system, if it is linked up with our system, will be able to achieve PvP or payment versus payment for the two currencies in real time. We already have PvP for Hong Kong dollar versus US dollar transactions the first in the world.

I have, as you are probably aware, drifted into the positioning of the Hong Kong bond market for meeting future challenges. We have, through our efforts in the development of the financial infrastructure, put ourselves in a position to play the ideal host to the bond market of the region, or of this time zone. I hope members of our financial community can leverage on this position of strength and bring issuers and investors of US dollar bonds to Hong Kong. Further development of the bond market is largely in their hands. As central banking officials, we in the Hong Kong Monetary Authority have done what we can appropriately do, in the provision of this public good a robust financial infrastructure. We can, of course, replicate this financial infrastructure for other currencies, and indeed we are currently exploring the possibility of doing so for the other major international currency not domiciled in this time zone the euro. And if this is appropriate, we can also transfer our technology to others through our advisory services. I am, in particular, thinking of the RMB financial infrastructure, which in my opinion requires urgent strengthening, not just for facilitating the development of the RMB bond market, but also for facilitating the many further measures in financial liberalisation following WTO accession.

Meanwhile, our US dollar financial infrastructure in Hong Kong, coupled with the market making arrangements that have been well tried for over a decade, and the critical mass of financial institutions, is ideal for the launching of a US dollar bond programme for the Mainland. I understand, of course, that with foreign reserves well exceeding US$ 200 billion, there is arguably little need for the Mainland to raise additional foreign debt. But part of the outstanding foreign debt could be refinanced in Hong Kong through such a programme. Perhaps with a liquid market and a reliable benchmark yield curve established, similar to those of Exchange Fund paper in Hong Kong dollars, the overall borrowing costs could be lowered. This seems worth trying, for the downside risks are minimal and the benefits could be substantial, to the Mainland in terms of potential savings in borrowing and road show costs, and to Hong Kong, in terms of consolidating our position as the regional bond centre.

And we are ready to play our part in the development of the RMB bond market in the Mainland, in accordance with the timetable associated with WTO accession, starting, slowly, with the establishment of joint ventures for underwriting and trading, and the development of RMB bond funds and so on. But what we hope for is that, in the fullness of time, the Mainland authorities can come around to accommodating full access to the RMB bond market from Hong Kong. I am sure there will be demand for RMB assets in Hong Kong, if the demand is not there already. I know that this matter, and other issues concerning financial intermediation of the RMB outside of the Mainland, raises complicated issues of capital account controls that need to be resolved cautiously. But I would like to reiterate my view that, with increasing economic integration between Hong Kong and the southern part of the Mainland, some, possibly an increasing degree of, mobility of capital between the two economies is inevitable. The choice is whether to channel properly this flow of capital openly and, if considered desirable, in a controlled manner, and to monitor it, or to leave it in the dark, when ironically it is performing the useful role in promoting the efficient use of capital in the two economies. There is a great deal that the free and open financial markets of Hong Kong can offer in RMB financial intermediation, and I am delighted that, at this important point in China's economic and financial development, one of the themes of this conference is how this can be effected. I wish you a very fruitful discussion during the rest of this forum. Thank you.