Joseph Yam: Financial integration and regulation

Remarks by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the conference: The Euro: Lessons for European and Asian Financial Markets, Hong Kong, 24 February 2006.

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Ladies and Gentlemen,

1. It is a great pleasure for me to open the proceedings of this conference on "The Euro: Lessons for European and Asian Financial Markets". It is also an honour for the Hong Kong Monetary Authority to be co-sponsoring this event with the European Commission. The programme is a very rich one and it will be impossible for me, in these opening remarks, to cover all the topics to be discussed later this morning and in the afternoon. I do notice, however, that the words "financial integration and regulation" appear in several of the session titles. These are topics close to my heart, because I have come to believe that they can influence profoundly how Asian economies develop in the years ahead. Well managed financial integration, combined with sound regulatory practices, can help the region maximise its economic growth potential while maintaining financial stability. I have chosen therefore to focus on these topics.

2. I will try and lay out a case for closer financial integration in Asia, both as a means of achieving more efficient allocation of resources in the region, thereby contributing to continued economic growth, and as a means of supporting financial stability. I will also discuss what concrete steps can be taken, and are being taken, to further financial integration in the region. Expanded intra-regional flows of funds do potentially expose financial institutions to new types of risks. Hence I will argue that regulators need to be vigilant as the integration process proceeds. Here in Hong Kong, we are actively working to implement the latest supervisory standards. This should ensure that our banking system will be ready to take on the new challenges associated with greater financial linkages in the region.

3. But let me start at the beginning, namely, the definition of financial integration and what benefits it is likely to bring.

4. The fundamental characteristic of financial integration is that net savers in an economy can have access to any investment vehicle regardless of the geographical location of either the saver or the issuer of the investment product. Similarly, entrepreneurs seeking funds to finance capital expenditure plans can, in a financially integrated area, have access to sources of credit irrespective of geographic location.

5. Put differently, financial integration permits the efficient transfer of funds between economic units that save in excess of their investment plans to economic units for which the opposite is true. As a result, net savers will receive the highest return on their funds, and the investors will obtain credit on the lowest available terms. In addition, financial integration enhances competition in each locality since savers and investors are not constrained to deal only with local suppliers of financial services, but can search for the most efficient supplier in the entire integrated area.

6. It is uncontroversial to suggest that financial integration within a given jurisdiction will be beneficial for the economy as a whole. Few would question that financial integration within the United States, for example, has made a positive contribution to that country's economy. And, I am sure that the increasingly comprehensive financial linkages across provinces in Mainland China, would make the mobilisation of the high savings and the allocation of capital there more efficient, leading to sustained economic dynamism. But the benefits of financial integration need not occur only within a single jurisdiction. Observing from afar the process of economic integration in Europe, it is clear to me that financial integration across national borders will make a positive contribution to the region's economic development. But I shall leave it to other speakers in our conference, particularly those with first-hand experience in Europe, to elaborate on that point.

7. Here in Asia, financial integration across economies has not proceeded as far as within either North America or Europe, even though the degree of economic, in particular trade, integration within the region has been rising sharply. As I have pointed out elsewhere, in the financial sphere Asian economies are less integrated with each other than with economies in the rest of the world. I believe that economic integration, brought about by market forces, having regard to comparative advantages in production, can best be served by financial integration of a similar degree.

8. I should emphasize, however, that this is as yet merely a belief on my part. I have so far found it difficult to provide empirical evidence to support my hypothesis that the optimal degree of financial integration is the same as, or close to, the degree of economic integration within a region. To start with, there are theoretical difficulties in identifying measures of optimality. In addition, there is no established measure of the actual degree of financial integration, let alone the actual degree of economic integration.

9. Lack of empirical evidence notwithstanding, one intuitively thinks that the synergy driving economic integration can best be harnessed financially by the stakeholders themselves, who know better what they are doing and take a longer term view, rather than by those, motivated largely by relatively short-term financial rates of return, and acting in accordance with credit assessments, conducted many miles away from where the action is.

10. Regrettably, for a variety of reasons, financial integration in Asia lags considerably behind economic integration. Currently, a sizable portion of gross savings in Asia finds its way into debt instruments of governmental and quasi-governmental issuers in industrialized economies, while investment in Asia is financed, to a significant degree, by capital from those same countries. This state of affairs seems incongruous and is a reflection of the relative lack of integration between the financial markets among Asian economies. It seems to me quite likely, that the cost of capital for enterprises in Asia would be lower, if there was a deep and well-functioning corporate bond market in the region to tap the considerable pool of savings, much of which now flows instead to industrial countries.

11. In the other direction, the dependence of regional investment on funds from external sources is not only incongruous; it also exposes the region to the 'sudden stop' phenomenon, whereby the flows of capital dry up abruptly, wreaking havoc with real economic activity. This well-documented feature of international capital flows, especially costly to emerging market economies, has unfortunately lead to greater policy conservatism towards financial openness, at least in this region, thus limiting and slowing down the pace of financial integration. But, in my opinion, it is for precisely this reason that financial integration in Asia should be pursued more vigorously.

12. One effective defence against volatile global financial flows is a large and financially integrated regional market. Speaking from experience, there is, I think, other things being equal, a non-linear relationship between vulnerability to financial instability and the size of financial markets. The very small financial markets are not attractive to international capital because of the lack of liquidity and so there is little volatility generated by the inflow and outflow of international capital. At the other extreme, where financial markets are very large relative to international capital, sudden movements of the latter will only lead to ripples, which are not big enough to cause any financial-stability concerns. The most vulnerable financial markets, other things being equal, are the medium-sized ones, which have adequate liquidity to attract international capital but which are, unfortunately, small enough for short-term trends to be dictated by large operators looking for short-term gains. There is also the temptation, for some, to engage in manipulative behaviour, amplifying volatility and vulnerability to financial instability.

13. I do not want to give the impression that the size of a financial market can substitute for sound macroeconomic policies as a guard against volatile capital flows. Indeed, I take it for granted that the authorities in the region are committed to prudent monetary, exchange-rate, and fiscal policies. But I am convinced that expanding the effective size of Asian financial markets through greater integration across jurisdictions, can increase the ability of our economies to absorb the volatility of international capital, as effectively as the US and European markets. It is therefore heartening to observe that several official initiatives towards greater financial linkages in the region are bearing fruit, notably the Chiang Mai and the Asian Bond Fund initiatives. I note that my colleague Julia Leung will describe the latter in some detail in the afternoon session.

14. Having made the economic case for increased financial integration allow me to spend a few moments outlining some practical steps that may be taken to achieve it. **First**, it is necessary to establish linkages between jurisdictions across the whole spectrum of financial infrastructure – the trading, payment, clearing, settlement and custodian systems for money and for financial instruments. This would facilitate the movement of savings between jurisdictions and make cross-border transactions more efficient. In this age these linkages are neither difficult nor costly to establish as the technology, in the form of electronic messaging platforms of acceptable security, is already available and in international use.

15. The **second** element concerns the relaxation of non-supervisory restrictions, where they exist, against access by foreign financial intermediaries to the domestic financial markets. The size of

financial intermediaries, measured for example in terms of capital, is often a barrier to market access; but, as we know, size is not necessarily a good indicator of quality. Capital adequacy, assessed objectively by reference to risk, provides a better safeguard. Greater competition, wherever it comes from, also enhances efficiency, although allowances should be made for the weaker domestic institutions to enable them to cope and find viable long-term solutions, in the interest of financial stability.

16. The **third** element concerns the harmonisation of standards in the financial system. A degree of harmonisation, at least the adoption of minimum acceptable international standards, is essential for improving investor confidence and enriching the flow of capital within the region. It would also be conducive to the stability and integrity of the financial system. I would emphasise the word "international" as there is no reason to develop regional standards different from those that have already been developed by international financial institutions and professional bodies, together with supervisory agencies.

17. The **fourth** element concerns the strengthening of co-operative efforts in financial system development. As I have already noted, in Asia we have been making good progress in our efforts to develop the domestic and regional debt markets through various regional forums and involving the international financial institutions. In the context of developing Asian Bond Fund 2, for example, we have achieved a few firsts, including the introduction of the first exchange-traded bond index fund in Asia, arranging for two Asian markets to allow exchange-traded funds for the first time, and opening up the renminbi inter-bank bond market for the first time to foreign investors.

18. The **final**, and probably most difficult, step towards creating an integrated Asian financial market involves the relaxation of statutory restrictions on cross-border capital flows. It is likely to be the most difficult, in part because it depends on the ability of the financial system in individual jurisdictions to cope with the ensuing risks.

19. This last point brings me to the next issue I wish to touch upon in my remarks, namely, the need for a strong and efficient regulatory framework that is adapted to the integration of the domestic financial system with that of other jurisdictions.

20. Greater financial integration across jurisdictions brings about at least two new sources of risk facing domestic financial institutions. The first and most obvious is the risk of currency mismatches when cross-border transactions involve the use of different currencies, as they are likely to do in Asia for the foreseeable future. Although monetary integration is a topic that is often mentioned in the region, its realisation, if indeed it occurs, is almost certainly going to take considerably more time than it will take for financial markets to become more closely linked. In the meantime, financial systems will have to be robust with respect to fluctuations in exchange rates that may impact assets and liabilities of financial institutions differentially. Of course, the financial turbulence in 1997 and 1998 has already alerted both regulators and the private sector to these risks, but if financial integration leads to increased cross-border financial commitments for domestic financial institutions, the size of the risks may become larger.

21. If integration has the desired effect of increasing cross-jurisdiction intermediation between savers and investors, or if it leads to cross-jurisdiction establishment of subsidiaries and branches, the nature of credit risks facing financial institutions may also change. Exposures to different business cycles will increase as will exposures to different sources of idiosyncratic risk. Supervisory agencies need to make sure that appropriate risk control measures are implemented in individual institutions, and that their capital adequately reflects the market, credit and operational risks they are exposed to as they enter foreign markets.

22. Here in Hong Kong we are well on our way to implementing the latest international standards in this respect, i.e. the Basel II standards. As the bank supervisor, the Hong Kong Monetary Authority has been working with banks and legislators to ensure that we are able to implement the new standards by 1 January, 2007. We have also been working with other regulators in the region through the EMEAP Working Group on Banking Supervision to share our experiences on the implementation process.

23. Ladies and Gentlemen, I have given you a brief personal perspective on financial integration and regulation in our region. I do not know whether I have convinced you of the importance of these topics for our continued economic prosperity and financial stability. But I certainly hope to have persuaded you that they are topics that deserve our attention whether we are policy makers, regulators of the financial system, or members of the private-sector financial community. I am sure that more will be

said about these topics throughout the conference, and I look forward to hearing from our European colleagues about the experience in Europe concerning financial integration and regulation in the Euro area.