Mr Latter gives an overview from Hong Kong of eight Asian economies

Keynote address by Mr Tony Latter, a Deputy Chief Executive of the Hong Kong Monetary Authority, at the Asian Financial Markets Conference held in Hong Kong on 26-27 April 1999.

Thank you for inviting me to address your conference today. It is encouraging to see such a wide and distinguished representation here from the financial and commercial communities. Indeed, when I looked down the advance attendance list, I quickly realised that there would be very little which I could tell you about market developments in Hong Kong that you didn't know already.

So, if you will allow me, I should like to spend some of my time standing back a little from specific market topics and looking instead of some of the macroeconomic forces which shape their development.

I shall focus my analysis on eight Asian economies [see table]. You will note that the list does not include Japan, Hong Kong or Singapore. That is because they can already be regarded as having relatively mature financial infrastructures and they are largely free of capital controls. Thus, for reasons which will become apparent as I proceed, they do not fit into the story.

The table shows the level of physical capital investment within each economy (specifically, gross domestic fixed capital formation as a percentage of gross domestic product) for the ten years to 1997. In most cases this was at a very respectable level; all figures fall in the range 22-38% of GDP on average for the period; by way of comparison, 1997 figures for USA, Japan and Germany were 18%, 26% and 19% respectively.

Also shown is the level of total domestic savings; this is the sum of savings by the household, corporate and government sectors (and may of course include dissaving by one or more of those). For certain purposes I would have liked to show the household component of the total, but sufficient data are not available. The third column displays second minus the first - i.e. the excess of savings over investment on these measures.

For all but two of the economies, domestic saving has outstripped fixed capital investment - in some cases by a substantial margin. But these figures tell us nothing about the intermediation process between saving and investment or about the role of financial institutions and markets. Much of the investment may take place within the same economic unit as where the savings arise, or be directed by government, without any requirement for third-party intermediation. Of course, if domestic saving is channelled into domestic investment mainly through government or other routes which are not subject to market discipline, allocative efficiency within the economy is likely to be impaired.

But a significant amount of investment may have no identifiable link at all to domestic saving, because savings have flowed out of the country through one channel and investment funds have flowed in through a completely different one. I shall return to this point in a minute.

Returning to the behaviour of domestic saving and investment, the chart shows the excess of saving over investment in graphic form. I have then added a column representing the recorded inflow of foreign direct investment. The latter may perhaps be regarded as the category of inflow likely to be most closely associated with physical investment. If you add that to the surplus of saving over investment (i.e. the two columns together), you can visualise in the majority of instances a significant potential over-funding of investment, even before taking account of any inflows of portfolio funds or bank finance which may head to the same destination.

Does this mean that there has in practice been more than enough money around in these countries to finance all desired investment? Of course not. As hinted earlier, I have failed so far to take any account of capital outflows. Part - in many cases perhaps a substantial part - of domestic savings is

exported. Unfortunately I do not think that it makes much sense to try to show specific statistics for such outflows, since in this field data are notoriously unreliable - the more so in instances where controls exist which encourage outflows through what are euphemistically called informal channels. But in general terms the existence of such outflows is strongly implied, if not actually identified, in the overall balance of payments figures.

Regarding capital outflows, allow me, for purposes of exposition, to make the following exaggerated distinction. In respect of advanced economies, outflows of direct investment tend to reflect the global workings of comparative advantage, as businesses seek to exploit particular strengths or niches; and portfolio outflows tend to reflect the search by each investor for a balanced international portfolio, within the total of which, however, domestic investments will typically tend to predominate. By contrast, in the less advanced economies there will be less wealth to provide the springboard for a large amount of direct overseas investment, and a large part of the leakage of funds from the country will be through what I have referred to as informal channels - which others may describe as capital flight. The position of any particular country in the spectrum between these two extreme characterisations will depend on, among other things, the stage of economic development that the country has reached, and on the degree of confidence that the population has in the government's policies and in the financial institutions.

The problem in many cases of the less developed economies is that firms and households tend to regard foreign assets as the habitat of first choice for any savings, reluctantly accepting domestic instruments as an - often enforced - alternative. The aim of the authorities must be to make domestic instruments the first choice, leaving foreign assets as the route towards subsequent more sophisticated or mature portfolio diversification. In this way, dependence on foreign inflows can be reduced, although there will always be an important and necessary role for them, especially in view of the technology and know-how transfer which may accompany them.

The 1997 Asian crisis, along with various subsequent problems with liabilities to foreign investors and lenders, have once again highlighted the vulnerabilities and volatilities which may be associated with overdependence on foreign capital, particularly that which is structured as debt. Yet in many countries there appears to be, as I have tried to demonstrate, a high rate of domestic saving which, if kept more at home and if, ideally, permitted to find a haven under the pull of market forces, could satisfy part of the funding needs for which foreign finance has in recent years been used.

Of course, not all countries enjoy a high savings rate in the first place and there may often be a need to encourage more domestic saving. But that question goes beyond the scope of my focus today, which is on what happens to those savings rather than on their scale itself.

The challenge to make the domestic employment of savings both more efficient and more attractive is one which must in part be addressed at the macroeconomic and political level. But it is also be necessary to develop the financial instruments and institutions to facilitate better intermediation within the domestic economy. In scope this might include anything or everything from basic deposit-based savings schemes for the small saver, through collective investment instruments, to the development or enhancement of the wholesale stock and bond markets. And, as I have already noted, there is a strong argument that the disposition of funds should be on a voluntary basis and according to market principles.

All of this leads me, by what has been an extremely circuitous route, to the point which I would wish to highlight to this audience today. Getting your firm's name onto the next tombstone for some high-profile international syndication, which may even qualify you for a photograph in one of those glossy monthlies, is all very well. But what about business opportunities to improve domestic intermediation in various countries? Of course, I am yet again exaggerating in order to make the point, for I know that most of you are already involved closely in domestic markets, not least Hong Kong's; but the

need for improved domestic intermediation in this region as a whole is being voiced with increasing frequency by officials of governments and international agencies, financiers and academics.

I have conducted here a fairly superficial analysis of a particular set of countries, in order to make a general point, which may be more relevant in some cases than in others. I am not going to be drawn into commenting on specific cases, since more thorough analysis would be required before reaching definitive conclusions. I leave you with, I hope, an incentive to explore some of the issues further if you wish. The challenge which I have identified - that of raising the efficiency and attractiveness of domestic financial intermediation - is not a new one, but an old one which has perhaps remained with us for too long. And I should add that the problem is one that is probably very much more serious in certain other parts of the world -for example, in some countries of the former Soviet Union - than in Asia.

I have managed to get this far without saying anything about Hong Kong, other than to exclude it from the preceding analysis. I ought now to redress the balance.

You will recall that one of my reasons for excluding Hong Kong was that I judged it to possess a relatively mature financial infrastructure. That certainly does not mean that we are necessarily satisfied with things as they stand. Indeed, I know of no financial centre in which the authorities are in that happy position. Given the speed at which product innovation takes place, often spurred by exponential leaps in the dimensions of technical feasibility, and the concomitant growth in global financial flows, which impinges relentlessly on an economy such as ours where capital controls are prohibited constitutionally, those of us who are charged with the task of ensuring the soundness and competitive efficiency of the financial system need continuously to evolve our stance on supervision and regulation, as well as to keep a watchful eye for any communal actions desirable to improve the workings of the financial system, where we might helpfully serve some catalytic function.

Let me mention just two areas of special attention in Hong Kong at present - without denying that there may be others too.

The first concerns the stock and futures exchanges, where there is a major agenda for change. Notable components of this agenda are the 30-point programme announced last September for strengthening discipline and transparency in the markets - most of which have now been implemented - and the proposals announced by the Financial Secretary in March to reform and unify the ownership structures of the stock and futures exchanges and their clearing houses. A tight timetable has been set and progress should be visible later this year.

The second concerns the development of the Hong Kong dollar debt market. This market has progressed considerably in recent years, with the evolution of the markets for Exchange Fund bills and notes, borrowing programmes by public sector bodies, fundraising by multinational agencies and sizeable funding programmes - mainly at the short end - by Hong Kong financial institutions. But, except for Exchange Fund bills, the secondary markets are not greatly active and there has been little activity by local private sector corporate entities to raise longer-term funds directly from the debt market. Perhaps the difficulty is simply that market conditions are seldom regarded as propitious on all fronts simultaneously - at present, for instance, the general level of interest rates may tend to discourage issuance at term. And there is definitely a chicken-and-egg problem in that prospective investors would like prior evidence of a liquid market, but liquidity cannot be tested until there has been issuance. Dilemmas such as these are certainly not unique to Hong Kong.

I acknowledge also that there are perceived obstacles concerning the tax regime, but it is worth noting that Hong Kong does have a low overall tax environment. It is hard to find solutions which fully satisfy all parties in such matters. It is also worth noting that, in normal market conditions, there is perhaps less incentive to exploit the potential of the local currency debt market than there might be in other centres, because of our pegged exchange rate: some borrowers may consider the US dollar

market a satisfactory surrogate, especially given its established liquidity. In that sense we may be a victim of our own success on the exchange rate front, although I would not wish to place too much weight on this point - it may be a viable alternative only for a minority. However, if funding needs can be properly satisfied via alternative routes, we ought perhaps to rest content. Our role at the Hong Kong Monetary Authority is to help ensure that the infrastructure will allow the market to develop if borrowers and lenders wish it to, rather than to force the pace artificially.

I believe, however, that there may be a stronger underlying interest in debt instruments among prospective borrowers and lenders than is currently visible on the surface. The move to list Exchange Fund notes on the Stock Exchange and the advent of the Mandatory Provident Fund are examples of potential significant new sources of demand for debt instruments. It is a challenge for all of us to identify and exploit these and any other pockets of latent interest. The Hong Kong Monetary Authority is in regular dialogue with the Hong Kong Capital Markets Association and we maintain an open mind, and an even more open ear, to ideas which people like you may have about the development of our markets. I should mention that we have regular contact also with the authorities of other centres in the region in order that we can gain from each other's experience in such matters.

Summing up, although I described our market infrastructure in Hong Kong as relatively mature, you will have realised - if you were ever in any doubt - that there is no shortage of change and of potential new opportunities, although possibly not so many as in one or two of the other economies, which I reviewed earlier. I hope that all of you will participate in the continuing evolution of Hong Kong's capital markets, and use Hong Kong as your base for incursions into other territories where similar or greater opportunities exist.

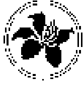
Our aim in Hong Kong is to provide an open and welcoming environment for business, and to be judged on our merits as a truly international centre which possesses that all important critical mass across the full range of financial, professional and commercial services and is ideally located as a hub for the region's future development.

Investment, Saving and FDI

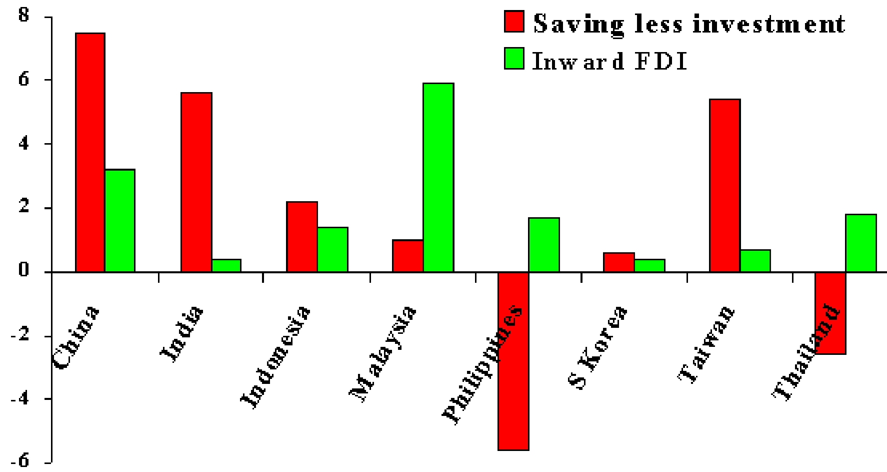
average 1988-97, as % of GDP

	Fixed investment	Domestic saving	Saving minus investment	Inward FDI
China	31.8	39.3	7.5	3.2
India	22.4	28.0	5.6	0.4
Indonesia	31.6	33.8	2.2	1.4
Malaysia	36.2	37.2	1.0	5.9
Philippines	22.0	16.4	-5.6	1.7
S Korea	35.5	36.1	0.6	0.4
Taiwan	22.2	27.6	5.4	0.7
Thailand	38.0	35.4	-2.6	1.8

Note: FDI=inward foreign direct investment; for India the first three columns are 1988-96, and
the fourth 1991-96.



Domestic saving less investment, and inward FDI; *1988-97, as % of GDP*



Note: Data for India are respectively 1988-96 and 1991-96 only