Mr Yam looks towards a stronger financial system in Hong Kong

Speech given by Mr Joseph Yam JP, Chief Executive of the Hong Kong Monetary Authority, at the Annual Dinner 1999 of the Hong Kong Society of Accountants on 29 October 1999.

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Introduction

I feel greatly honoured to have been invited to speak at this year's Annual Dinner of the Hong Kong Society of Accountants. I must confess that I became a little worried when I checked up on the list of speakers at your Annual Dinners in the past 10 years. I realise that, in accepting this speaking engagement, I have taken on the almost impossible task of performing to a standard that may well be beyond me. I shall nevertheless try my best not to make you feel that you have gone down market. You are of course well aware of the close working relationship between the accounting profession and the Hong Kong Monetary Authority. Your involvement in all our many advisory committees and in regulatory compliance of the financial institutions we supervise is crucial to our work, and I take this opportunity to thank you all for your help and forbearance in our ever-increasing supervisory demands. As a gesture of gratitude I shall this evening steer well clear of the irksome domestic supervisory issues. Instead I shall focus on the broader subjects of economy and finance as we recover from the financial turmoil of the last two years.

Economic performance

The economic numbers that came out in the past few months seem to convey a clear message, and this is that the economy has, since the second quarter of this year, been slowly but steadily recovering from the painful recession, which had lasted for about eighteen months. The growth rate of GDP moved back to positive territory in the second quarter of this year, having been in negative territory, year on year, for six quarters. The unemployment rate has peaked. Asset prices have recovered. Retail sales have picked up. Tourist arrivals have increased. Exports have started to grow again, with the external trade account at the same time moving into surplus. The fall in consumer prices, adjusting for the effects of the generally welcome rebate of rates and lowering of rentals, has stabilised. Monetary conditions have remained stable, although we could do with lower interest rates. The overall quality of bank assets, and the mortgage portfolio in particular, has improved. On the fiscal side, although I am not privy to any information that has not been made public, I have the fullest confidence in the skills of the Financial Secretary in his management of the public finances. As the economy recovers, the fiscal position should quickly move back into overall balance.

An 18-month period of sharp recession and painful adjustments is, of course, very tough for everyone. But this does not seem to be an excessively long period, given that we were affected by the worst financial turmoil in the recent history of the region. I am aware, however, that there has been some controversy over the performance of the Hong Kong economy, compared with that of other Asian economies, in coping with the Asian financial crisis. There seems to be the impression that Hong Kong has been the slowest to recover. This may be true according to one measure or another, and we should obviously look critically into the reasons, if indeed there are structural defects that may have inhibited our recovery. Economic cycles come and go, and there is no way that Hong Kong, as an open and externally oriented economy, can be immunised from external shocks of the dimension that we have seen. But we need to make sure that we come out of the crisis stronger rather than weaker. Structural defects, if any, need to be corrected decisively, to the extent that this is within the powers of Government to do so.

But we also need to keep our heads cool and be objective in this self-assessment. The loud and heartfelt complaints of a community in pain, legitimate though they may be, can sometimes drown out the arguments in support of policies that are in the long-term interests of Hong Kong. It may therefore be worth making a few observations on how the policies we pursue have helped Hong Kong through the crises that have hit this region over the past couple of years.

First, while Hong Kong may be one of the last economies in the region to move back into positive economic growth, it was in fact also one of the last economies to go into recession as a result of the financial crisis.

Second, currency stability has protected our real incomes. Indeed, we emerged from the recession with one of the smallest falls in average incomes for our community, measured in US dollar terms.

Third, Hong Kong's monetary and financial systems also experienced the least structural damage. And, at the height of the crisis, we were also able to introduce various effective measures to strengthen them.

Fourth, our currency has remained the most stable in the region. Operating under robust currency board arrangements, our exchange rate link to the US dollar has remained intact, and its credibility has increased.

Fifth, the necessary structural adjustments in the economy have been taking place efficiently, more so than in many of the other crisis-hit economies in the region. The fixed exchange rate has the effect of forcing the inevitable structural adjustments to take place quickly throughout the economy, rather than taking the easy way out through currency depreciation. The experience of Asia has clearly shown that adjustments through currency depreciation can easily get out of hand by setting off a financial meltdown, unless the process of currency depreciation is guided by exchange controls or credit restrictions. And, even then, the structural adjustments can probably only be postponed, not obviated.

I hope that in pointing out these aspects of Hong Kong's performance in the Asian financial crisis I have not given you the impression of being complacent or defensive. I am aware of the need to address such important issues as Hong Kong's competitiveness and the provision of credit to small and medium-sized enterprises. But what I have mentioned are aspects which have, I fear, been very much neglected in the domestic discussions about Hong Kong's performance in the financial crisis. But the fact of the matter is that, notwithstanding all the doom and gloom descriptions and predictions, and the death sentences that have been pronounced on our city, Hong Kong has performed reasonably well. The impact on Hong Kong of the Asian financial crisis has been severe. But we have stuck it out and, by and large, we have managed without catastrophes.

Controversy

It is true that we have had to take unconventional and controversial actions in the financial markets. But regulators do have a responsibility to deal with market failures, which in our case arose from market concentration and manipulation. The few of us involved received a lot of criticisms as a result, and some of these were not pleasant, particularly the accusations that we betrayed the free market. But I hope the way the matter has played out, and the handsome book profits that we are making, will serve as a vindication of our decisions. And, in case it has crossed your mind, luck has had very little, if any, to do with it, although I do not mind luck being on my side. The whole explosion of international finance has simply gone too far. If it were not the default by Russia, some other event would have caused yield spreads to widen sharply. If it were not LTCM, then some other hedge fund would have needed the massive de-leveraging that, had it been allowed to take place, threatened dislocation even in the largest market in the world. Some event, large or small, would have triggered all that. As some of you may remember, the sharp correction in the stock market in Hong Kong in 1973 was triggered by the Fire Brigade being sent in to inspect overcrowding on the then rather small trading floor of one of the stock exchanges before unification. Incidentally, the widening of the yield spreads that caused problems for LTCM last year actually started when we entered the market in August, according to a chart prepared by Stanley Fischer of the International Monetary Fund (IMF). It gathered momentum as Russia defaulted. So perhaps we played a part in turning around the sentiment of international finance last year.

And let me say this also: knowing well my close colleagues who fought this battle together with me, it would, I think, be difficult to find stronger believers in the free market than those of us in the Hong Kong Administration. A few names will, of course, spring to your mind immediately, but my response is that we work in the real world and not in ivory towers. The fact of the matter is that free markets can sometimes fail. Free markets can sometimes behave in a manner very much against the long-term interests of society. When this occurs, if those of us in the Administration hide conveniently behind the banner of free markets and do nothing, we are failing in our duties. And to those who accuse us of betraying the philosophy of positive non-interventionism, let me ask this question: why do you think Sir Philip Haddon-Cave used the word "positive" when he coined the phrase?

International finance

But perhaps enough has already been said on that subject. Let me now move to the longer-term structural issues of concern to our monetary and financial systems. As I said earlier, we need to ensure that we come out of the crisis stronger rather than weaker. We need to identify structural defects, if any, and address ways of correcting them, not necessarily limiting ourselves to our own systems, given the globalisation of financial markets.

You may be surprised to hear that we started a form of this exercise immediately after the tequila crisis in early 1995, well before the continuation of that crisis, now best described as the crisis of international finance, hit this region. While we were able to put together domestic contingency measures, some of which in the event had to be invoked, consideration of issues, involving as it did cooperation at the international and regional levels, took time. In any case, I must confess that none of us involved in this work, in Hong Kong and in the regional forums, were able to appreciate, let alone predict, when and how the crisis would hit us and how severe it would be. There was a lack of urgency and an abundance of scepticism about regional monetary cooperation. We have since pushed much harder in the international and regional forums, to the extent, I fear, that we might have become a little too noisy for the comfort of those who are, for one reason or another, in favour of maintaining the status quo in the international financial architecture.

Indeed, of great concern to us is the inadequacy of the international financial architecture to cope with and harness the explosion of international finance. The size and volatility of global capital flows have grown tremendously relative to the global economy. Global output has grown by 26% between 1990 and 1997, before the financial crisis hit us. Global trade in goods has grown faster by 64%. But global finance, however measured, has grown much, much faster. Stock market capitalisation and turnover surged by 153% and 282% respectively. Foreign exchange turnover more than doubled during this period, and has now grown to roughly 70 times of merchandise trade.

You have seen the consequences of this disproportionate growth of international finance in many parts of the world, in Latin America, in Asia, in Russia, in Central Europe, and in South Africa, where the associated volatility of capital flows posed serious problems. Even in the US, where the largest markets in the world operate in what must be the most favourable economic environment seen for many decades, the destabilising potential of international finance was brought home by LTCM.

Let me hasten to point out here that the rapid development of international finance is not necessarily a bad thing. Indeed, the phenomenon has been one important factor contributing to increasing global prosperity. Much of the Asian miracle as we know it, during the long period of prosperity before the financial turmoil broke out in July 1997, was brought about by financial liberalisation. The crucially important process of financial intermediation, in which savings are channelled into productive investment, has been made a lot more efficient. Money is no longer stored under mattresses, but is, through placements with banks, and investments in debt and equity and their ever-proliferating derivatives, put to productive use farming land, building homes, manufacturing goods and providing services. Financial liberalisation has further taken this process of financial intermediation to the international level, in which, for example, UK pension funds are invested in Thai equity and US depositors are funding infrastructure investments in the Philippines. And this is not a one-way process either. A large part of Asian savings - to the extent that they are increasingly allowed, by the relaxation of exchange controls - to be invested overseas, have been funding the budget deficits of developed economies and providing capital, for example, for Microsoft, Citibank or British Telecom. Indeed, the Asian miracle would not have been possible without the advent of international finance. But, alas, it was also international finance that was responsible, at least in part, for turning the Asian miracle into Asian misery.

International financial architecture

In the history of this world, it has not been unusual to see the riches of a family surpassing the wealth of a poor nation. However, with a free and open global trading system, economic differences generate opportunities for business interactions of mutual benefit. The sharing of that benefit has nevertheless been the subject of controversy, where the distinction between doing business and exploitation is blurred. But then this is a fact of life, with different perspectives when viewed from different angles. And so arguments arising from such issues as protectionism and dumping remain, and there are established institutions and mechanisms, as part of the global trading system, to tackle them at the international level. And despite all these imperfections, history has shown that, with the increasing freedom of international trade, the world is in many ways a better place to live in.

I believe that the same sentiment can generally be applied to international finance. Indeed, in much the same spirit as in the promotion of free trade, a great deal of effort and commitment has been put into the promotion of the free flow of capital in recent decades. Financial liberalisation became very much the fashion, leading to domestic financial markets rapidly attaining a global dimension, welcoming and absorbing international capital. This created opportunities for international financial intermediation, channelling savings into productive investments across countries and across currencies, enhancing the efficiency in the use of global capital and contributing to promoting global economic growth and development.

But, as in the case of international trade, there is also a need for institutions and mechanisms to deal with the undesirable aspects of international finance. We now have a situation in which individual financial institutions are in a position to mobilise financial resources larger than the Gross Domestic Product of an economy. They can take dominating positions in particular markets and dictate short-term market movements in their own interests. Small open markets have become increasingly vulnerable to international capital. Whilst many of them have benefited greatly from an abundance of international capital, both in the form of foreign direct investment and foreign portfolio investment, they have also become easily overwhelmed by such flows. Yet there is no equivalent of a World Trade Organisation to deal effectively with the problems that inevitably would spring up, even though the degree of complexity and time criticality of international finance far exceed that of international trade. There is, of course, the IMF, and the Bank for International Settlements (BIS). They perform useful roles respectively in providing assistance to individual economies in difficulty, and in setting international regulatory and supervisory standards, and they have done a good job in these areas. But, as very much part of the international financial architecture, they need to evolve to cope with the rapidly changing nature of international finance. They need to ensure that they are able to play the roles required of them in prudently managing the risks, and limiting the destabilising impact, of the increasing freedom of international finance.

There is much catching up to do, and much international effort has been devoted to this task. But, presumably because of the difference of opinion on what exactly needs to be done, we now have a rather confusing picture of where all this effort might lead us to. There have been many new international forums created to look at the relevant issues and, together with the existing forums, everybody seem to be involved in this work - G3, G7, G10, G22, G26, APEC, EMEAP, etc., with multiples of working groups formed under each. More recently, there is the more authoritative Financial Stability Forum formed, in which the HKMA participates. Yet another ‘G’ - the G20 - is in the process of being established. Hong Kong’s significant voice on the subject means that some of us have to be travelling and attending international meetings all the time. Yet our extensive involvement is necessary if the plight of the small open markets, particularly those that are international financial centres, is to be adequately heard and taken into account in the reform of the international financial architecture.

International reform

Our stance in these discussions is that we support the free flow of international capital but that there is a need to limit its destabilising influence on financial markets, particularly those in small open economies. And specifically we point to the two interrelated aspects of excessive volatility and inadequate transparency that need to be addressed. Volatility is largely the result of herding behaviour, which is in turn the result of the lack of information on which market participants can make rational decisions. All this is made a lot worse when, because of the lack of market information, particularly in the case of the over-the-counter markets, market concentration develops, whether consciously or unconsciously. And market concentration has a tendency to lead to market failure and possibly market manipulation. The international solutions we put forward, therefore, are greater disclosure and, where applicable and practicable, enhanced regulation.

It is in our reference to market manipulation that I think we touched a few raw nerves, particularly against the background of the controversial action we took last summer. While there is wide sympathy for our decisive action against market manipulation, we have been cautioned by some on the need not to be confused by herding behaviour. Others have challenged us to come up with hard evidence that manipulation existed, reminding us of the established academic theory of market manipulation, and urging us to examine carefully the history of the events leading to last August, collect data and conduct econometric research into them.

While I agree that all these need to be done where possible, I must tell you that such advice reminded me of what Andrew Crockett, the General Manager of the BIS and Chairman of the Financial Stability Forum, once told me. He said that the economic theorists are those that attempt to look in a dark room to find a black cat. The economic historians are those that attempt to look in a dark room to find a black cat that is not there. And the econometricians, who conduct all those regression analyses from the data collected, are those that attempt to look in a dark room to find a black cat that is not there and say that they have found it. I certainly do not wish to be involved in that sort of thing. But there is surely one thing that ought to be done, if we are serious about the matter. Using the same analogy of the dark room and the black cat, why don't we just light up the room and look? But then, some may fear that instead of finding a black cat we shall find a fat tiger taking up much of the room, playing havoc, tearing up things, creating chaos and not wanting anybody to know about it.

I firmly believe that the *disclosure* of relevant information by market participants will make markets work better. This could be done directly or indirectly through regulators and special purpose agencies such as credit registrars or custodians. The information should include data that will enable the financial position of significant market participants to be assessed objectively, such as their degree of leverage and their exposure to specific markets. This would help counterparties, such as the banks extending credit to them and the investors using their services and entrusting their savings to them, to take decisions based more on rational analyses rather than on herding behaviour. The information should also include data that will enable overall market positions and their concentration to be established. This would help the regulator in effectively ensuring systemic stability, taking regulatory action where necessary to manage or limit the systemic risks or simply to disclose publicly the relevant aggregate information for the benefit of all market participants.

This is of course easier said than done. When you are dealing with international markets operating over the counter, with participants possibly registered in cyberspace, how and on what authority do you obtain that information, or impose regulatory measures, desirable as they may be? And even when such information disclosure requirements are successfully imposed in a particular market in a particular jurisdiction, and regulatory measures put in place, would there not be the danger of the market migrating offshore? Market participants are quite willing to take advantage of opportunities for disclosure or regulatory arbitrage that individual offshore centres may be keen in introducing so as to attract business.

These are among the questions now being asked in international discussions. The task of achieving greater transparency in international finance is no doubt a difficult one, but it is in the interests of all developed and emerging markets - to support this initiative, to light up the dark room. And without going into the technical details, let me say this: with adequate international cooperation, involving all the significant financial centres, this is achievable. Regulatory authorities from these centres may just have to be a little more forceful. They could collectively say that these are the disclosure rules we have laid down on the basis of international consensus, under the auspices of an authoritative institution on international finance.* They could further emphasise that the disclosure rules are essential safeguards for systemic stability in international finance that is in the interests of all. If you wish to operate in our markets, or make use of our market infrastructures, including effecting any payment or settlement arising from relevant transactions, as participants or as intermediaries, you have to follow these disclosure rules and ensure that you deal only with those who follow these rules.

The *regulation* of international finance is even more difficult, but I think the same cooperative spirit can be applied, if indeed regulation in whatever form is considered necessary. But then, looking at the situation facing the key players in a position to influence the direction of this important reform, I doubt whether the political will is there to make changes of this nature. Views of strong domestic lobbies may prevail and urgent domestic issues may divert attention. As you may know, it is not the desirability of reform, nor the technical feasibility of the details, that dictates action or inaction, it is, regrettably, more often than not, the political reality. Meanwhile, international discussions on this subject are moving into a critical stage when we will either see results or see much recent effort jettisoned as momentum is lost.

Regional initiatives

What recourses, then, are left to small open markets such as our own to enable us to pursue the legitimate goal of ensuring monetary and financial stability? Not a lot, I am afraid. We can certainly tackle the smallness, in terms of building bigger markets and effective shock absorbers, but I would be really loath to see openness tackled, for this would imply restrictions and controls that undermine the efficiency of international financial intermediation and hamper the potential for economic growth and development.

Elsewhere, I have addressed a few times the question of how we can build bigger markets through regional cooperative efforts. The idea of an Asian Monetary Union is far-fetched. I would be the first to admit that, even though I also claim to be the first to draw attention to the idea publicly. So I will not go into that now, or the subject of regional monetary cooperation, except to say that we shall continue, for the time being, to urge the building of a more robust financial infrastructure for the region, and the improvement and harmonisation of regulatory and supervisory standards. These need not be pursued or be seen as preludes to further steps in a particular direction in the context of any wider regional initiative, but purely as things desirable in their own right, managing risks and reducing the probability of systemic problems occurring.

We have a number of regional initiatives in this area, and have made some, but slow, progress. There are the liquidity assistance arrangements in the form of the bilateral repurchase agreements we initiated and put in place in 1995. Then there are the standing invitations from us to other central banks in the region to have their real-time gross settlement (RTGS) payment systems, when constructed, linked up with our own. And if such linkages are also established among themselves then we will have a robust network of RTGS payment systems to facilitate the safe transfer of money in this region. We also have another standing invitation to others to have debt clearing systems similarly linked up to form what we would like to call the Asiaclear, to facilitate investment flows across markets in this region. This will also help the development of a regional debt market. We shall persevere with these efforts.

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* This could be a reformed IMF or a BIS with enhanced roles. Or it could be a new World Finance Organisation (WFO), mirroring the WTO.

Domestic responses

On the domestic front, we all, in the first place, have to put our own house in order, if indeed there are shortcomings in economic policies generally, or monetary and financial policies in particular. But one lesson from the financial crisis is that, even if you are white as snow, you are still vulnerable to the vagaries of international finance, and will continue to be so, if they are not satisfactorily addressed soon at the international or regional levels. This vulnerability makes the authorities, particularly those of small open markets, uneasy, as the task of maintaining monetary and financial stability has become a very onerous one.

For the purpose of self-fortification, the small open markets need to make greater efforts to strengthen domestic monetary and financial systems. They may need to do so to such an extent as to go beyond established practices and standards of the large developed markets, simply because there is greater risk for them than for the larger markets of being overwhelmed by international capital. This approach will involve costs, and this should be recognised and accepted.

First, it may require substantial resources - witness the enlargement of the monetary base in Hong Kong to build a big cushion to absorb the impact of volatile short-term capital flows and to reduce the sensitivity of interest rates to those flows. This involved committing over US$10 billion of our foreign reserves as a shock absorber. We can afford this, but this may not be the case for other small open markets.

Second, it may also involve the regulators playing a more proactive role in market development, anticipating and pre-empting systemic problems. This is very much the background to the banking reforms now in train, to the public discussions about consolidation of the banking sector, and also to the merger of the exchanges.

Third, it certainly requires a much higher degree of cooperation and coordination among different domestic regulators, and for each to take into account the wider cross-market issues that have a bearing on systemic stability. This means a greater regulatory burden for all and greater inconvenience to market participants, and possibly implications for the legal and institutional arrangements for regulation.

Fourth, this approach may involve tighter rules for the markets. The critics may again say that this will further erode market freedom. But should we be so dogmatic? In any case, it is all a matter of degree. In the end, it is the public interest that counts. Is there, for example, anything wrong in restrictions against the holding of large dominating positions in any particular market, or against the taking of market moving activities? The purpose of a market is price discovery. There is no objection for buying low and selling high, and I would wish anybody who is attempting that the best of luck. But there is no legitimate reason for anybody to be operating in a market in a manner that has the sole aim of moving the price in order to make a profit. Tighter rules aside, it is interesting, and indeed slightly worrying, to note that stronger forms of restrictions and controls have been gaining currency among some monetary authorities or regulators in the past two years. These range from restrictions on domestic credit to some forms of exchange controls. This response is quite understandable and may be a reflection of the failure of the international financial architecture to accommodate the needs of small markets. But it is also regrettable, given the enormous benefit that international capital has brought to the region.

For the immediate future, self-fortification, in one form or another, will probably continue to be a prominent policy feature in the management of the monetary and financial systems of small open markets. This is one reason why we in Hong Kong have been pressing ahead with many domestic reform initiatives to strengthen our monetary and financial systems. There are many proposals still on the table. We need to make quick progress, for the current reprieve as the highly leveraged institutions lick their wounds may not last for long. In my opinion they have not met their Nemesis yet. We should not assume that they have, nor should we necessarily wish that they should, remembering that free and open financial markets have been generally beneficial to economic growth and development. Our objective is to harness this process while limiting the destabilising influences. And so let us also continue to push hard for the reform of the international financial architecture. We need to persevere on all the IRD fronts, and by this I mean the international, regional and domestic fronts, and not the Inland Revenue Department that is loved and hated by accountants.