Mr Yam: Risks and challenges in coping with international capital flows

Opening address by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Sixth Manila Framework Group Meeting, held in Hong Kong on 20-21 March 2000.

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Ladies and Gentlemen,

On behalf of the Hong Kong Monetary Authority, I would like to extend a very warm welcome to all of you to this Sixth Meeting of the Manila Framework Group.[1]

As you will no doubt recall, the Manila Framework Group was founded in the deep throes of the Asian financial crisis in November 1997 to develop a concerted approach to restoring financial stability in the region. With the worst clearly behind us, and with signs of a strong economic recovery in the region, the mission of this group has still not ended. This forum embodies a valuable spirit of cooperation, with wide participation of emerging market economies in the dialogue. The value of this forum lies in its quality dialogue on regional surveillance and on reform of the international financial architecture.

There is no doubt that economic recovery in the region has gathered considerable momentum. Economic growth for most economies has been better than expected, external balances have improved remarkably, international funds have renewed interest in the region's asset markets, and yield spreads of Asian sovereign bond issues over the US treasuries have narrowed notably. According to estimates by the Institute of International Finance, net private capital flows into emerging markets in Asia increased nearly six times from 1998 to US$39 bn in 1999, and are forecast to increase again by 50% to US$59 bn in 2000. There is therefore a real danger that we might forget the severe pains inflicted by the Asian financial crisis over the past two years. It is also easy to forget the lessons learnt and to become complacent. However, if the recovery in the region is to be sustainable, we should remain vigilant and beware of the risks lurking under these bubbling activities.

Risks and challenges in coping with international capital flows

Challenges of domestic structural reforms

In order to address such risks, we would need to tackle three challenges faced by Asia. *The first challenge is that the globalisation and liberalisation of markets require structurally sound and resilient domestic systems.* Prior to the crisis, the banking systems were often inadequately supervised and were prone to incurring excessive maturity mismatch risks by borrowing short-term funds to finance long-term investments. Moreover, the corporate sectors of many Asian economies were over-stretching themselves by engaging in risky or unproductive investments. To make things worse, both the banks and the corporates were taking excessive currency risks by borrowing in foreign currencies to fund projects that could only generate income in domestic currencies. Poor risk management on the part of banks, ineffective banking supervision, political interference, and a critical lack of transparency prevented disciplinary mechanisms from functioning properly. The result is a staggering bank restructuring cost of an estimated 25% of GDP for the crisis-hit economies in Asia.

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[1] The Manila Framework Group is a forum comprising senior finance and central bank officials from 14 economies, namely, Australia, Brunei Darussalam, Canada, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Thailand, the United States of America. Senior representatives of the International Monetary Fund, the World Bank, the Bank for International Settlements and the Asian Development Bank also attend the meeting. The Group meets twice a year.

Since the outbreak of the Asian financial crisis, economies all over the region have taken important strategic steps to promote conditions that foster a full and speedy recovery. But recovery cannot be sustained unless it is accompanied by thorough structural reforms. It is encouraging to see that notable initiatives are taking place in Asia where extensive programmes are in progress to restructure and recapitalise banks. There are also efforts to tackle the problems posed by over-stretched and highly indebted corporations. But there is a risk that the problems that were so evident then will be swept under the carpet in the face of rapid growth. It is crucial that the reform momentum should not be allowed to falter, as it could undermine the fledgling recovery.

Challenges of monitoring and surveillance of capital flows

The second challenge I see is to understand better the risks posed by volatile capital flows and how to capture data to facilitate our understanding of such flows. For a long time it has been taken for granted that capital flows are analogous to trade flows: that, wherever they occur, and in whatever form, they invariably benefit long-term economic development, and that therefore the more liberal the flows, the greater the benefit. But between the processes of trade liberalisation and financial liberalisation there lies a great difference. In the case of trade liberalisation, there are well-established statistical systems to capture data on international trade, and hence their impact on the real economy. In addition, there has been parallel development of institutional framework and rules to deal with trade measures like tariffs, quotas, subsidies and dumping, and also counter-measures, and there are mechanisms for dispute settlement and arbitration. In contrast, the statistical framework for capital flows is, relatively speaking, very modest. And we do not have any framework to deal with disruption caused by volatile capital flows comparable to the World Trade Organisation's mechanisms for handling disruption from trade in goods and services.

The volume of global merchandise trade, valued at US$5.4 trillion in the year of 1998, in fact pales beside the scale of global international finance. The average daily turnover in the world's foreign exchange market stood at US$1.5 trillion in 1998, or roughly 70 times that of merchandise trade. On top of that, the OTC derivative contracts had a daily turnover of US$1.3 trillion in 1998, and the notional amounts outstanding at end-June 1998 came to US$72 trillion. There is no doubt that the growth of foreign exchange and OTC markets, together with advances in information technology, has contributed to cross-border capital flows and enhanced risk management standards. It is, however, legitimate to ask what lies behind these vast numbers. What does it mean for the underlying markets if the financial derivatives trading continues to multiply? Do we understand exactly what these US$72 trillion worth of derivative positions represent? Do we really understand the nature of the fund flows generated from the financial derivative trading in the OTC markets?

The problem is that we do not have the answers to most of these questions. To start with, there is not even an adequate statistical framework to capture capital flow data. The current data on balance of payments, international investment position, or flow of funds accounts have two major short-comings: (a) low frequency of quarterly data; and (b) limited breakdown of data by currency, sector, instrument, etc. The BIS, IMF and OECD are examples of institutions which have made some attempts to collate relevant statistics but they are far from complete or timely.

This is not just a statistical issue for the data compilers but a major policy issue for the authorities and other users. The compilation of high-frequency and detailed data is going to be resource-intensive and there is keen competition for statistical resources. It seems to me high time to take a fresh look at the adequacy of data on capital flows and if necessary review the priorities currently assigned to collection of real sector or other statistical data.

Challenges of coping with the destabilising impact of highly leveraged institutions

The third challenge I should like to touch upon is how to cope with the destabilising impact of highly leveraged institutions (HLIs). The issue is how to improve the stability and functioning of the financial markets for all market participants. As there have been extensive international discussions in this regard, I shall briefly recapitulate the key developments and the challenge ahead.

The Asian financial crisis has shown that the highly competitive and globalised financial world has created individual market participants that are huge enough to mobilise, often with the help of leverage, financial resources larger than the GDP of smaller economies. They can build up dominating positions in the markets of smaller economies and influence short-term market movements either singly or through acting in concert. Combined with the lack of information on the OTC market, the highly leveraged institutions can develop potentially excessive and destabilising market concentrations, whether consciously or unconsciously.

Under these circumstances, there are two types of scenario where HLIs could pose concerns in their interaction with financial markets. The *first scenario* is a situation in which HLIs taking excessively large positions are overwhelmed by market forces. Rapid deleveraging of positions in markets associated with the default of an HLI of the size of LTCM could have systemic impact even in large and mature markets, thereby threatening the global financial system. It has been said that a repeat of the like of an LTCM debacle is most unlikely to occur, given the downsizing of hedge funds. I certainly hope that this is the case but I also notice that the recovery of investor sentiment has seen more money from institutional investors as well as high net worth individuals flowing to the hedge funds.

The *second scenario*, commonly known as the “Elephants in the Pond” problem, is a situation whereby the HLIs take very large and concentrated positions in smaller financial markets and adopt aggressive trading practices that could be destabilising to such markets. It is very encouraging that the “Elephants in the Pond” problem is by now recognised quite extensively as a real issue to be tackled.

What is being done and is it enough?

Different approaches have been floated to tackle the problems arising from the two scenarios I just described. The prevailing approach is *through improving counterparty risk management*. This is done indirectly by asking the banks and other financial institutions to be more prudent in granting credit lines to the HLIs, and directly by encouraging the HLIs to enhance their own risk management standards. This is eminently logical and sensible, since with more cautious bank lending and enhanced risk management within the HLI sector, it should be very hard for the HLIs to build up excessive leverage and concentration in the major financial markets.

This measure is being pursued with earnest in both the public and private sector. The Basel Committee on Banking Supervision, and IOSCO have issued respective guidelines on sound practices for interactions with HLIs for banks and securities firms. The latest discussion has focused on the kind of supervisory incentives for the compliance of risk management standards. The Basel Committee on Banking Supervision has put forward two proposals for the revision of the Capital Accord, which would help address the concerns on HLIs. One is abolishing the maximum 50% risk weighting for non-bank OTC derivatives exposures; and the other is encouraging counterparties to impose an initial margin on repo transactions.

From the private sector, the Counterparty Risk Management Policy Group formed by twelve leading international financial institutions produced a report in June 1999. Five major hedge funds also produced an industry group report in February 2000 on improving counterparty risk management and internal control.

While we agree that enhanced risk management of HLIs and their counterparties is a useful first line of defence, two major concerns remain. *First*, the return of competitive pressure may lead to a relaxation or even a breakdown in risk management standards again in the future. There is anecdotal evidence that some large HLIs are becoming less willing to supply information to their counterparties as memories of the LTCM saga are fading. It is thus important that regulators continue to promote the introduction of suitable supervisory incentives that would encourage continued compliance with sound risk management practices by the financial institutions.

Secondly, these proposals may not be sufficient to resolve the problem faced by smaller and open markets. Even with reduced overall leverage, HLIs could still build large foreign exchange positions relative to these markets. It might also be possible for HLIs to build up potentially destabilising positions in smaller markets while remaining inside internal limits on leverage and/or liquidity risk. Enhanced risk management cannot therefore be relied upon, in isolation, to alleviate the problem.

A second proposal to enhance market stability is *to improve transparency and disclosure to make markets work better*. There have been two major international initiatives in this respect, one at the firm level and one at the market level. *At the firm level*, there is the Multidisciplinary Working Group on Enhanced Disclosure, chaired by Peter Fisher of the Federal Reserve Bank of New York, which has developed a disclosure template for individual firms to voluntarily disclose their risk exposures. This initiative is breaking new ground, as it is the first time that the private sector would be providing more information about their risk exposures. However, the usefulness of such disclosure depends very much on the level of breakdown in the risk disclosure.

Furthermore, the US President's Working Group on Financial Markets recommends (a) a reporting framework for large hedge funds to disclose more meaningful and frequent market risk information to the public, and (b) a requirement on public companies to disclose information about their material financial exposures to HLIs. A challenge here is for other authorities to take similar steps to require such standards of disclosure, as this would help to avoid the possibility of regulatory arbitrage.

At the market level, a working group set up by the G10, and led by Jean-Pierre Patat of the Banque de France, studied the feasibility of collecting and disseminating aggregate positions data in the foreign exchange market. I believe the initiative, if implemented, could have helped smaller and open markets in better understanding their currency markets and the accumulation of highly concentrated positions. However, in November 1999, the G10 Governors decided not to proceed further with work in this area. In making this determination, the G10 found that there were a number of practical limitations to the proposal, including the difficulty in obtaining compliance, the unfeasibility of producing the data in a timely manner, and the substantial costs involved. The demise of this initiative left a vacuum in the area of transparency on market concentration. This is unfortunate and the international community should explore other alternatives to bridge the information gap.

I have mentioned two approaches, that of enhanced counterparty risk management and improved transparency and disclosure, which will hopefully help to address the concerns on excessive leverage and on opaqueness of HLIs. There remains the issue of aggressive trading practices, such as taking extreme measures to manipulate prices and to precipitate herding or panic selling by other market participants. Such practices undermine market stability. I therefore call upon the private sector market participants to review matters and devise a code of conduct to improve the standard of market behaviour and practices. For such a code to be effective, I believe it needs to be market specific and applicable to all market participants in that market.

Conclusion

Ladies and gentlemen, it has often been said that history, especially financial crisis, tends to repeat itself. In the last ten years alone, we have had the ERM crisis in 1992, the Mexican peso crisis in 1994/95 and the latest Asian crisis in 1997/98. Notwithstanding the disturbingly frequent occurrence of seemingly similar financial crises, I am inclined to believe that even though no two crises are exactly the same, if people do not learn from past mistakes, the market will continue to repeat its punishment. The only difference between the major financial crises in recent years is that the punishment is getting more and more severe, if not violent.

I have cited three major challenges to learn from the mistakes in the last financial crises. First, domestic structural reforms. Secondly, monitoring and surveillance of capital flows. Thirdly, coping with the destabilising impact of HLIs. They are by no means exhaustive. However, if we, individual economies and the international financial community, can muster the determination to tackle these challenges, we will go a long way in helping to reduce systemic risks, and improve the functioning of the international financial system and the stability of the financial markets. While much domestic and international efforts have been devoted to these issues, there is still much catching up to do. This is precisely the reason why we gather here today - to take stock of progress, exchange views on the unfinished reforms, and work for a more robust and safe domestic as well as international financial system for all of us.