Joseph Yam: East Asian financial markets - the next frontier

Welcoming remarks by Mr Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the conference on "East Asian Financial Markets - The Next Frontier", Hong Kong, 22 June 2006.

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Ladies and Gentlemen,

It is a great pleasure for me to welcome you to this conference on "East Asian Financial Markets - The Next Frontier". It is also an honour for the Hong Kong Monetary Authority to be co-hosting this event with the World Bank to discuss the findings of its latest Regional Financial Sector Flagship Study and the future development of the financial markets in Asia. The World Bank has been very supportive of economic development in the region and I particularly welcome the focus in its recent work on financial markets. Here in Asia, considerable efforts have been made at the individual economy and regional levels to further develop our financial markets. Much remains to be done, however, so it is with great anticipation that I look forward to the discussions, conclusions, and recommendations that will emerge during the coming two days.

The title of the conference, "East Asian Financial Markets - The Next Frontier" is, I believe, very fitting. Each part of it carries an important message. The focus on financial markets reminds us that a well-functioning financial system is increasingly important for economic development. This is not only the case for economies like ours here in Hong Kong where financial services constitute a substantial proportion of GDP, but equally for economies that rely on other sectors, be they manufacturing, mining, or agriculture, for the bulk of economic activity.

There are many reasons for this. First, a well-functioning financial system helps allocate capital to the most productive individuals, firms, and sectors through the process of intermediation between households that engage in savings and entrepreneurs who require funds to carry out investment projects. Second, broad financial markets permit risk sharing and diversification, thereby reducing the exposure of investors to idiosyncratic risks. Third, structured financial products allow the transfer of risk to entities that are most capable of bearing it. This makes it possible for economic agents to offload risks that they are not well equipped to deal with and specialize in activities which constitute their comparative advantage. Last but not least, a financial system makes it possible to shift purchasing power across time as individuals build up financial assets while they are working to sustain a comfortable living standard in retirement.

Considerable progress has been made by many regional economies in revamping and strengthening the financial markets since the Asian financial crisis. However, there is still a general lack of diversity in the channels of financial intermediation, with a significant over-reliance on the banking system. In spite of the brisk primary and secondary market activities in a few stock exchanges in the region, capital markets, in particular the bond market, remain rather underdeveloped. There is much more to be done, therefore, to further develop the financial markets by the regional jurisdictions.

The second part of the conference title - 'The New Frontier' - also contains an important message. Globalisation and the revolution in information technology have fundamentally altered the dynamics of international finance. Such changing dynamics raise concerns among many of us about the manner in which a sizable portion of gross savings in Asia finds its ways into financial obligations of the developed markets before they are recycled back to Asia. As the capital inflows into the region tend to be more volatile, the recycling process may have implications on monetary and financial stability in the region. Another aspect of the dynamics of international finance is contagion. World interest rates have until recently stayed at record lows. In search of higher yields, hedge funds and other institutional investors have scoured the world for assets generating higher returns, driving up asset prices and driving down credit spreads. As the interest rate outlook has become uncertain, fund managers may be reassessing the risks of emerging market assets, as reflected in the recent correction in world equity and commodity prices. A sudden exit of capital could leave those economies with weaker financial systems even weaker, with spillover effects on other parts of the region. All these developments highlight the need to explore and develop a new frontier of regional cooperation in Asia, particularly for the development and integration of financial markets, and build a bigger market to cope with the changing dynamics of international finance.

The development of deep and sound financial markets must start at home. Only the relevant authorities within each jurisdiction have the ability to establish a regulatory and institutional framework that will permit and encourage the growth of a vibrant private financial sector. All of us in the region understand this and are working individually to improve our domestic markets, albeit from very different starting points, which explains the differences that still exist among us in the size and sophistication of our financial markets. But the development of the financial sector in each economy is limited by the size of our domestic markets unless we open our borders to international trade in financial services and the establishment of foreign financial institutions on our territories. Banking and finance are subject to economies of scale and scope, so the expansion of the effective market size is necessary to make the provision of financial services more efficient.

In addition to taking advantage of economies of scale and scope, the case for integrating financial markets across jurisdictions is simply an extension of the case for developing the markets within each economy. The gains from financial intermediation across jurisdictions, from international risk diversification and risk sharing, and from access to financial instruments to fund pension schemes are multiplied when we allow individuals, enterprises and fund managers access to each other's markets in addition to our own.

Clearly there is a case for linking markets together in order to be better prepared to withstand possible turbulence in global financial markets. Speaking from experience, there is, I believe, 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 small enough for short-term trends to be dictated by large operators looking for short-term gains. Unfortunately, many financial markets in the region fall into this category.

Of course, merely increasing the size of a financial market cannot be a substitute for sound macroeconomic policies as a guard against volatile capital flows. Indeed, I believe that the authorities in the region are committed to prudent monetary, exchange-rate, and fiscal policies. But I am also convinced that expanding the effective size of Asian financial markets through greater integration across jurisdictions, can make our economies better able to absorb the volatility of international capital as effectively as the US and European markets. It is therefore heartening to observe that several initiatives for promoting the development of the financial markets in the region are bearing fruit. A notable example is the Asian Bond Fund (ABF) initiative championed by EMEAP central banks. The ABF has been created specifically to encourage the development of bond markets in Asian economies, with the ultimate goal to create an integrated regional market. In developing the ABF, 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. The process leading up to the launch of Asian bond funds has shown that cooperation between central banks in the region can successfully deal with a number of technical and conceptual issues, which bodes well for the further development of this initiative as well as potential initiatives in other areas of financial market development.

The successful experience of ABF has laid a strong foundation for enhanced regional cooperation by central banks to promote financial integration in Asia. There seem to be at least three aspects in which further development of central bank cooperation may be useful. The first concerns the continuity of the research and discussion processes in the respective areas of central bank cooperation. Continuity helps keep track of the emphases and priorities of regional members and promotes effectiveness of the ongoing collaboration efforts. The second aspect concerns the need to follow through cooperative initiatives that have been agreed upon by central banks in the region. The follow-through can be done effectively through intensified, and perhaps more conveniently organised, dialogue and information sharing. The third aspect concerns the approach towards central bank cooperation. There are many areas of common areas of interest among regional central banks, including monetary and financial stability, payment systems and reserve management, to name just a few. In short, there is a need to organise central bank cooperation in a more focused, coordinated and dedicated manner in order to pursue our common interests.

Today, with the World Bank experts and policy-makers, regulators and private-sector participants of the region gathering here, the conference will offer us a good opportunity to exchange views on what is needed to further promote regional cooperation and financial integration in Asia. We will also cover more specific subjects including the broadening and deepening of securities markets, the development of securitization and derivative markets, and the role of the contractual savings and asset management industries in the development of capital markets. As I have suggested at the outset, advances on these fronts will contribute to the overall gains from financial development through more effective financial intermediation, more efficient risk sharing and risk management, and increasing opportunities to make transactions between time zones smoother. Each requires modifications in domestic regulations and institutions as well as significant coordination between jurisdictions. I believe that progress in one area will be reinforced by progress in the others in a virtuous circle. I am impressed by the extensive work carried out by the World Bank in its Flagship study, and I once again thank them for their contribution to the economic development in the region through this work.

Ladies and Gentlemen, with these brief opening remarks I hope I have conveyed how important I believe the topic of our conference is, and how pleased I am to see you all here to participate in the event. I wish all participants productive discussion in the coming two days. Thank you.