Norman T L Chan: The future of Asia's finance

Welcome remarks by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the IMF-HKMA Joint Conference, Hong Kong, 28 February 2014.

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Good morning, Deputy Managing Director Zhu Min, Counsellor Jose Vinal, Ladies and Gentlemen,

1. It gives me great pleasure to welcome you to this Conference jointly organised by the IMF and the HKMA. The theme of this Conference is "The Future of Asia's Finance". In order to predict the future, one must understand and learn from the past. If we don't understand where we are and what has brought us here, it is very hard to predict where we will be in the next 5–10 years.

2. Asia's finance is now at a crossroad. We have to decide where we want to go and how to get there. This is not the first time and won't be the last that Asia's financial markets are facing this situation.

3. The last time Asia was at a crossroad was 1997/98 after the eruption of the Asian Financial Crisis. In the two to three decades before mid-1990s, Asia produced a couple of economic miracles: the emergence of the Four Asian Dragons and four Asian Little Tigers, all of which went through phenomenal economic growth and significant rise in living standards. However, unlike the developed economies in the West, Asia's growth in this period was propelled mainly by bank finance. Massive amounts of capital, mostly in the form of external bank borrowings, flew into Emerging Asia during this period. In 1997, total amount of international bank lending to Asia amounted to US$840bn. Most of these external finance were denominated in US dollar and with rather short tenor. Of course we now understand this kind of external finance is very risky as it entails currency mismatch and maturity mismatch. But these risks were simply ignored or brushed aside while everybody was enjoying the Asian boom prior to 1997. Then the bubble burst and the crisis-hit Asian economies all learnt very important lessons in a bitter way by paying a heavy price.

4. Since the Asian Financial Crisis the Emerging Asia has implemented many structural reforms and has now re-emerged as stronger and more resilient economies.

5. As a result, Asia, once again, has gained centre stage and, until the last year or so, become the preferred destination of international capital flows. Unlike the 1990s, the structure of finance in Asia has changed because external bank borrowings, although still quite significant, have been overtaken by bond borrowings. Around 80% of bond issuance in the last three years in major Emerging Asian economies was denominated in domestic currency, thereby reducing currency mismatch risk for the borrowers. Moreover, the average tenor of the newly issued bonds has steadily been lengthened to 6.3 years in 2013, which would mitigate the risk of maturity mismatch and short term roll-over risk.

6. It therefore seems that the Asian banking and financial markets are moving along the right track and we should congratulate each other for this accomplishment. However, I am not entirely sure if Asia can afford to feel complacent because I believe Asia's finance is still facing many short-run and longer term challenges. In the interest of time, I would just highlight two key challenges.

a. Short-run challenge: clearly this has to do with the Fed tapering and the normalisation of the US interest rates. The key question is to what extent the unwinding of the dollar carry trade, which prevailed for over 5 years since the collapse of Lehman, would lead to significant outflow of funds and tightening of market liquidity across Asia. The risk of a "new normal" causing a rise in interest rates, re-pricing of assets and a slow down of economic growth would be a big challenge for Asia in the next year or two.

b. Longer term challenge: there are many structural reform challenges for Asia's capital markets, but today I would just focus on infrastructure financing. It is beyond doubt that Asia needs heavy investments in infrastructure in the next decade or two. Some have estimated the amounts of funding needed for infrastructure financing to be in the order of US$750 bn a year. At the same time, Asia has accumulated a huge amount of savings, which are more than adequate to finance the infrastructural investments in the region. Unfortunately in reality what may seem to be a perfect match does not exist in Asia. A large part of the savings in Asia have been channelled through the banking and other financial market channels to the advanced markets and then part of these savings are channelled back to Asia. This pattern of flows has created several problems. Most importantly, with the implementation of Basel III, banks no longer find it attractive to lend to long term infrastructural projects because of the higher capital charge required to hold these assets on their books. More specifically, many European banks, which were very active in infrastructural financing in Asia in the past decade, have reduced their exposures in this area and will continue to do so in the future. So many infrastructural projects in Asia are now finding it increasingly difficult to secure the necessary finance. At the same time, many bankers and fund managers have said that there is still ample supply of funds looking for investment opportunities, but lending or investments in Asia's infrastructure has been greatly hampered by the shortage of "bankable" projects. So on the one hand Asia has a huge funding need for infrastructural projects but on the other bankers and investors sitting on huge amounts of savings complain that they cannot find sufficient "bankable" projects. Clearly there is a big gap here. There are many reasons why such gap exists, involving factors relating to legal, governance and political risks for investing in Asia's infrastructure. Whatever the reasons, we must endeavour to find a workable solution to narrow the gap or else it will significantly impair Asia's growth potential as well as constraining the development of Asia's financial markets.

7. In conclusion, I would say that today's Conference is very timely as it will discuss the key challenges facing Asia's finance in the future. Asia is now at a crossroad and we must work together to choose the right path. I have no doubt that this Conference will contribute useful insights and advice on this very important subject. Thank you.