Eddie Yue: Financial markets in Asia - turning challenges into opportunities

Speech by Mr Eddie Yue, Deputy Chief Executive of the Hong Kong Monetary Authority, at the International Swaps and Derivatives Association (ISDA) 34th Annual General Meeting, Hong Kong, 10 April 2019.

* * *

Thank you for inviting me to speak at the ISDA Annual General Meeting. For those of you coming from overseas, let me welcome you to Hong Kong and the very dynamic Asian region. By now, I hope you have experienced and enjoyed the vibrancy of the city. Indeed, this same vibrancy runs through Asia, which has got strong economic momentum with a promising outlook. But as central bankers, our job is to be on the lookout for future challenges and how to overcome them. So today I'd like to start by outlining two near-term risks on my radar screen, and then discuss two longer-term challenges for Asia. I would then offer some thoughts on how financial sector developments, including a lot of the efforts that ISDA has been involved in, can help overcome these challenges.

Challenges for the Asian Economies

Asia has seen remarkable economic growth over the past several decades – its GDP, on a purchasing power-adjusted basis, now accounts for more than 44 percent of global output, up from just 30 percent in year 2000. Living standards have improved dramatically, and per capital income has more than tripled over this period. Behind this incredible economic momentum are globalisation, investments, and supportive government policies, factors expected to continue to drive the region for the foreseeable future. Indeed, the Asian region is expected to grow at 5 percent per year through 2023, easily topping all other regions of the world.

Robust regional economic development has benefitted Hong Kong, just as the services we provide as an International Financial Centre has benefitted the region. Hong Kong offers an excellent platform for global businesses and investors, governed by a well-established legal system, backed by a resilient banking sector, and supported by its geographic and cultural proximity to China. Our city has become a global leader in IPO fundraising, bond issuance, asset management, and renminbi products. In addition, innovation – both financial and technological – is a key policy priority and is at the heart of the city's future plans.

But underlying this promising trend for Asia is a number of challenges. The most important downside risk to our region at this juncture is the China-US trade war. Some negative spillover effects of the three rounds of tariffs have already been experienced by various Asian economies, as we have seen exports slowing in a number of economies. Here in Hong Kong re-export volumes destined for China or the US that are on the tariff lists fell in the fourth quarter of 2018. While we're all hopeful that a resolution is on its way, we should also be prepared for further damage to businesses and confidence if the conflict continues to linger.

Another near-term risk is the recent shift in the stance of monetary policy in the advanced economies from tightening to accommodative. In principle, this could be beneficial to Asian currencies and investor sentiments; but it could also be the impetus to new rounds of capital flow "surges-and-flights". It's therefore imperative for our region to manage and allocate the surges efficiently with the view that there may be a potential reversal later on.

Turning to longer-term challenges, a key one for Asia is adaptation to China's ongoing economic transformation. We have already seen some economies in the region benefitting from this transformation in recent years, by stepping into certain manufacturing sectors that China has exited, while others have boosted participation in China's value chain, especially in high-tech sectors. The continued opening up of capital markets means that financial linkages between China and other Asian economies will also become tighter.

But amid this transition is the possibility that an economy ends up being left out because it didn't adapt effectively. I'd imagine, for example, that economies overly dependent on exports geared toward filling China's investment demand may lose out to those that focus on supplying consumption goods and providing financial services. So while I don't see China's economic transition leading to "black swans" for Asian economies, the risk would be for economies to "fall behind" in the process.

Another longer-term challenge—and one that's perhaps most important—is the chance that some economies in our region might fall into the so-called "middle income trap". The middle income trap is the phenomenon that many emerging economies slow markedly as per capita income approaches a certain level, typically estimated to be around US$20,000. Many important economies in Asia are already approaching that level, so we should all be thinking about this challenge before it's too late. Trends such as population ageing, a slowdown of urbanisation, low productivity as a result of overinvestment, and the lack of financial market development are generally cited as the causes of the middle income trap. One would think that the reversal of these trends could help economies evade the trap, but this of course is easier said than done.

Crucial Role of Financial Market Development

While issues such as population ageing are probably best left to other forums, those of us here today are well-suited to think about how financial market developments can help Asian economies overcome the two longer-term challenges. Informed by Hong Kong's blueprint as an International Financial Centre, let me share a few thoughts on this issue.

First, both longer term challenges – navigating China's economic transition, and evading the middle income trap – require Asia's financial institutions to be tech-forward. Around the world, we have seen fintech play a key role, with innovations ranging from the digitalisation of traditional banking activities, to ones aimed at promoting financial inclusion. At the HKMA, we have been proactive in using technologies to make financial services more accessible, especially for consumers and SMEs.

Over the past year, we have launched Open API, a framework that allows third party providers to aggregate information about the products and services offered by different banks for the benefit of end-users. Licences have now been granted to three virtual banks, with potentially more on the way, which will enhance the spectrum of products and services available to retail customers and SMEs. Another application launched was Faster Payment Systems or FPS, a 24/7 retail payment platform that offers cross-bank, cross-eWallet transfers in Hong Kong dollar or RMB. All that's needed is the recipient's phone number or email address. We have also introduced applications that help corporations: the eTradeConnect platform, for example, uses DLT-based technology to bring the paperwork-heavy trade financing business into the digital era.

Other Asian economies have also been actively engaged in fintech solutions that help make access to financial services easier for their constituents. Without a doubt, a lot more work still needs to be done on fintech, especially when compared with other areas such as e-commerce and social networking where the impact of technology has been and continues to be immense.

Second, Asian economies need to continue to promote long-term investments and stable capital markets. Research has firmly established that well-functioning financial systems are crucial to economic development, and that capital mobility in particular is beneficial for middle income economies. One particular development I'd like to highlight, and one that's quite fitting for discussion at today's forum, is the development of derivatives markets. Derivative markets offer cost-effective ways to manoeuvre investments; more importantly, they are effective risk mitigation tools. In the context of Asia, where cross-border flows are large and where opportunities for foreign investors are plentiful, derivatives can help investors deploy capital without being subject to excessive short-term price fluctuations, by hedging out currency and interest rate risks. The upshot here is that capital can then be allocated to usages that benefit long-term economic development in the region.

Now, I note this as a "development", because there's plenty of room for growth in Asia's derivative markets: according to a recent report by the Committee on Global Financial Systems, or the CGFS, in most Asian economies, average daily trading volumes for derivatives remain strikingly low compared to advanced economies, even those that are not major financial centres. In addition, almost half of the market participants surveyed by the CGFS expressed at least "some" concerns that the functioning of derivative markets in emerging market economies in general do not adequately complement their respective capital markets, with about 20 percent indicating "significant concerns". Aside from the limited turnover size, I suspect that geography also plays a role in this rather downbeat assessment – many Asian-related derivative trades are in fact not booked or risk-managed in Asia!

To me, the market's opinion is clear: derivative markets in Asia need to be further developed. Let me share some recent experiences in Hong Kong in this regard. By daily average trading volume, our interest rate and FX derivative markets have almost doubled since 2013, and are now first and second, respectively, in terms of regional market share. Notwithstanding this growth, Hong Kong still only accounts for a small global market share, and the products we cover – both in terms of contract type and underlying currency – has a lot of room to expand.

We have therefore taken a proactive approach by encouraging international banks to establish derivative hubs serving Asian risks in Hong Kong as long as they meet capital adequacy requirements and our risk management standards. Establishment of these hubs can help banks take advantage of Hong Kong's double tax agreements with all key economies in the region; more importantly, our city's growing status as a nexus between Mainland China and the rest of the world means that Hong Kong will play an increasing role in providing risk management solutions for international investors going into China and, increasingly, Chinese investors going global, just like how we successfully facilitate those investments through our Connect schemes. Our commitment to further developing the derivatives market is strong and we stand ready to work with various partners on this.

One key current issue is benchmark reform. As discussed over the past two days, many economies in Asia have been working on this, as this reform is important not only to derivative markets, but also to bank lending. The HKMA has actively engaged our banks to identify their exposures to the benchmark rates of relevance (i.e., LIBOR and HIBOR) and to prepare for various scenarios that could play out during this process. At the same time, the Treasury Markets Association in Hong Kong has proposed HONIA as an alternative risk free overnight reference rate to HIBOR and is consulting industry stakeholders. I should take this opportunity to mention that ISDA's leadership on two important implementation issues – namely, how to adjust new overnight reference rates for longer tenors and how to ensure credit risk premiums are reflected – helped pave the way for constructive discussions in Hong Kong. So overall, progress is being made.

Managing the Risks in Financial Market Development

Whether it's facilitating fintech innovations or deepening derivatives markets, it's critical that a robust and adaptive regulatory framework and effective international coordination are in place to mitigate potential financial stability risks. The types of regulatory framework would depend on the stage of development in the market itself. For markets that are going through innovation, particularly those that are adopting new technologies, regulations should focus on "nurturing" rather than "restraining".

As an example, the HKMA and our peer authorities in the region have adopted fintech sandbox regimes, which are effectively testing grounds with a well-defined scope and a clear timeline. The authorities do not generally stipulate an exhaustive list of regulatory requirements in these sandboxes; rather, the products are to be developed flexibly, and requirements would be evaluated during the process. Coordination among regulators has also already begun as the Global Financial Innovation Network (GFIN) is now inviting applications for cross-border testing of financial innovations. That said, while providing a conducive environment to support innovation, central banks and regulators would have to strike a good balance with its other functions in consumer protection and financial stability, especially as the new and innovative services grow in scale or become widely adopted. Cross-border coordination is also required to address potential arbitrage across jurisdictions, given the much wider reach of fintech products and services.

Derivatives markets, on the other hand, have a much longer history. The regulatory framework should therefore be informed by history, and lessons from the global financial crisis must not be forgotten. Regulators need to guard against the problems that plagued derivatives markets before the crisis: namely, the overuse of leverage, excessive interconnectedness, and opacity. I don't need to "preach to the choir" on the tremendous efforts exerted by regulators and market participants internationally to solve these problems. But I do want to remind ourselves to stay vigilant and ensure that implementation is seen through, as this work has not yet been completed.

For example, initial margin requirements on non-cleared derivatives, which guard against the overuse of embedded leverage in derivatives, are still being phased-in in a number of jurisdictions including Hong Kong. At the same time, while derivative transactions that are intended to be cleared has increased five-fold in the past four years in Hong Kong, according to data from our Trade Repository, there is more room for further standardisation. Finally, solutions such as deference mechanisms, which helps eliminate cross-jurisdictional regulatory arbitrage, are still works-in-progress between the HKMA and our overseas counterparts. As we embark on further deepening of the derivatives markets in the Asian region, the high standards set up by regulators and by the industry over the past ten years should be well respected, and strengthened regulations on margins, clearing, and transparency should be taken seriously as safeguards against potential risks.

Let me close by saying a few words about our host today. ISDA has been instrumental in promoting standardisation of documentation and practices in derivatives markets. In the process, it has played a key role in navigating the industry through post-crisis reforms. ISDA is and will continue to be an important platform for consensus building and knowledge sharing. I'm certain that ISDA will remain a valuable partner for everyone in Asia as we continue to overcome the challenges I discussed today. I look forward to more fruitful collaboration going forward.