Mr Yam discusses financial stability, region and international co-operation

Speech by the Chief Executive of the Hong Kong Monetary Authority, Mr Joseph Yam, at the 32nd Asian Development Bank annual meeting, in Manila, the Philippines, on 2 May 1999.

Introduction

I am delighted and honoured to have the opportunity to speak to this distinguished international audience. The theme of the forum is regional monetary and financial co-operation. From the point of view of time, venue, sponsors, and participants, it would, I think, be very hard to come up with a more appropriate topic than this. In terms of timing, our region is currently, we hope, moving through the final stages of a period of financial and economic dislocation that has taught us a number of lessons. The most important of these lessons, in my view, and one consistent with the aims of this forum, is that we need to intensify international and regional co-operation to reduce the risk of such crises occurring again. The venue for this forum, Manila, is one of the oldest international financial centres in Asia: it has also been the starting point for a number of important modern regional initiatives. Manila has given its name to the recently established Manila Framework, within which central banks and finance ministries in the region meet to promote regional co-operation on financial matters. The beginnings of systematic economic co-operation can also be traced to Manila, with the establishment here, in 1966, of the Asian Development Bank (ADB).

The ADB, one of the sponsors of this forum, has played a vital role in nurturing growth and technical advances in Asian economies, and this role has in recent years both deepened, in the assistance it has been offering, and broadened in the geographical scope it has been covering. The ADB’ s joint sponsorship of this forum is one of many examples of the good work it is doing to address regional concerns. The co-sponsor of the forum, the Institute of International Finance (IIF), has, in two timely and important reports issued in March this year, argued strongly for private-sector, as well as public-sector, initiatives to address global financial crises. The co-sponsors have brought together a diverse and experienced forum of participants from private-sector and public-sector organisations, all of which have a large stake in ensuring that our regional and global financial systems work properly.

The Hong Kong Experience

As a regional and international financial centre, Hong Kong’s livelihood depends, perhaps to a greater extent than other economies, on the proper functioning of the international financial system. Our stake in this, arguably, is larger than other economies. This perhaps explains why we seem to have been quite forthcoming, in both our views and our actions, on issues affecting international monetary and financial stability. This unusual stance has caused some controversy, particularly when we intervened last summer in the stock and futures markets to deter market manipulation and correct market failure. Interestingly, the controversy over this issue, which has now happily subsided following the success of the operation, was then more intense outside of this region than within, and was especially strong in the developed markets. I would attribute this difference in sentiment to the relative lack of appreciation, outside of this region rather than within, of the predicament that smaller, open markets face in the increasingly liberalised international financial system.

Hong Kong supplies a particularly striking example of this vulnerability. Our markets are very free and open. They are big and liquid enough to attract substantial international capital. But they are also small, by comparison to the developed markets and the amount of international capital flowing around the globe, seeking opportunities for profit. They are small to the extent that the prices of those markets are capable of being pushed around by big players, particularly those in a position to influence market sentiment. Being a very externally oriented economy, we pursue an exchange rate policy that promotes a stable external value for our currency to provide for predictability for all those who engage in economic activity relating to the predominant external sector. In pursuing this policy,

we have gone as far as to adopt currency board arrangements that operate with a high degree of transparency while eschewing the exercise of discretionary monetary management. This eclectic combination of characteristics and policies, which is quite a common feature of economies in this region, offered great temptation to market manipulation.

Such manipulation is often well timed and co-ordinated with the advance or reversal of capital flows, since essentially the same market players, acting in the multiple roles of advisors, agents and principals, are involved. One inevitable consequence of this is market panic and overshooting, to the extent of risking a meltdown in the monetary and financial systems concerned. The authorities, obviously, have a responsibility to act to prevent this from happening. Some have been in a better position to do so than others, using market means, particularly those with deep pockets. Some have been forced into closing their markets, albeit temporarily. Others have been quietly happy that they had been a little more conservative in their move towards financial liberalisation. In Hong Kong, where our commitment to maintaining open markets is strong, in addition to our unconventional market operation, we had to introduce measures that have effectively built us a big cushion. The purpose of this cushion is to help us to absorb the spasmodic international financial shock waves of mammoth dimensions that can now be generated by the international financial system. Some others, regrettably, have had to suffer the debilitating consequences of financial meltdown, and to face the often unjust accusation that these were entirely of their own making.

Domestic responses by economies in this region cannot on their own address the root of the crisis or lessen the chances of another international financial shock wave. One thing that we have learned from this episode of financial turmoil is that, no matter how well maintained the domestic financial environment may be, problems remain in our increasingly liberalised international financial system that cannot be resolved by individual jurisdictions alone. There is a need for regional and international co-operation. Hong Kong has not, of course, been alone in this view. There is now international consensus that something needs to be done, if not on what exactly should be done, in reforming the international financial architecture.

Financial Crisis: Local, Regional or International

The financial crisis is basically an international one, and I think it is now generally accepted as such. But, when the financial crisis erupted nearly two years ago in Thailand, and even when it was already spreading rapidly throughout the region, the explanations put forward by the experts then were largely local ones: macro-economic imbalances in the crisis-hit countries, cronyism, poor regulation, policy errors, and so on. Consistent with these explanations, the assumption was that the International Monetary Fund (IMF) and the multilateral development banks would fix it country by country, as they had done before in other localised crises elsewhere in the world. We therefore saw a series of policy adjustment programmes and financing packages targeting specific economies. These international financial institutions deserve much credit - far more than they have received - for mobilising, sometimes in a matter of days, financing packages totalling US$400 billion.

But in a new and rapidly changing international financial system, the instruments that the international financial institutions have at their disposal seem to be increasingly inadequate. They soon found out that they can no longer use traditional strategies to deal with novel and unprecedented problems thrown up by constantly changing technologies and ever more sophisticated market practices. The striking thing about these problems is that they erupt without much warning and to the surprise of even the most knowledgeable in this field. They are also not specific to individual economies: market liberalisation and globalisation have made them common problems for all economies that wish to play a part in the international financial system. Indeed, with a few economies in Asia going through the same process of financial liberalisation and encountering the same problems, the crisis was characterised as one specific to Asia, hence the reference to the Asian financial turmoil.

But explanations of the financial crisis soon moved from regional to international. Events in Russia and Latin America, the Long Term Capital Management (LTCM) episode, and the subsequent de-leveraging of hedge funds soon made it clear that our regional crisis was more than just a problem of a few individual economies not keeping their houses in order. The root of the crisis is in the great increase in the speed, quantity and unpredictability of international capital flows. And many of these capital flows are mobilised or indirectly influenced by highly leveraged institutions operating behind a veil of secrecy interlaced with esoteric mathematical models that do not allow the systemic as well as the rather simpler counter-party risks to be identified, let alone properly managed. As recent events in this region and throughout the world have shown, this phenomenon has reached a level where it is capable of disrupting even the largest markets and completely destabilising smaller markets. It will therefore be useful for us to discuss these issues in greater detail before focusing on what needs to be done.

International Capital Flows

For a long time it has been taken for granted that capital flows are exactly analogous to trade flows: that, wherever they occur, and in whatever form, they invariably benefit long-term economic development, and that therefore the looser the rein they are given, the greater the benefit. This presumption, however, has been questioned recently in light of the experience of some emerging market economies. Professor Bhagwati, for example, in his article last year on " The Capital Myth" , has argued that the assumption that free capital is as virtuous as free trade is wrong and that the claims of enormous benefits from free capital mobility are not persuasive.

There are undoubtedly many benefits that go with free mobility of international capital. Traditionally, capital flows take the form of commercial bank lending, foreign direct investment, or equity portfolio investment. Over the past few decades, these flows have facilitated the efficient cross border utilisation of capital and have provided liquidity in financial markets. By adding an international dimension to financial intermediation, the mobility of international capital has clearly been helpful in promoting growth and development in both the capital exporting and the importing economies. The mobility of capital has more recently been boosted by advances in telecommunications and information technology, allowing capital to move into or out of an economy in huge amount and within a very short space of time. The virtue of capital mobility therefore carries the risk of capital volatility. The volatility is destabilising in both directions. Too rapid a build-up of capital inflows places severe upward pressure on domestic asset prices, fuels inflation, and exacerbates macro-economic imbalances. Conversely, sudden and massive reversals of these flows place intense downward pressure on the exchange rate, and therefore upward pressure on interest rates, causing asset bubbles to burst and splatter. When rapid build-up is followed suddenly by massive withdrawal, we see the kind of crisis that swept across this region in 1997 and 1998.

The volatility of international capital flows is also attributable in part to the phenomenal growth of derivatives and the global over-the-counter (OTC) market in the past decade. A survey by the Bank for International Settlements (BIS) in June 1998 estimated the size of the global OTC derivatives market at an aggregate notional value of US$70 trillion. Despite the trauma of the global financial crisis last year, there have been no signs of an overall slowdown. According to the US Federal Reserve Board, the notional value of derivatives contracts outstanding at US commercial banks, the leading players in global derivatives markets, grew by more than 30% last year: this is the most rapid annual growth since 1994.

The sheer volume of derivatives trading does not say much about their associated risks. These new financial instruments have undeniably helped investors to unbundle their risks. They have promoted investments and generated substantial benefits to the developing countries receiving such investments. However, the availability of derivative instruments has also increased the opportunities for speculation that resulted in significant losses with the downturn in markets during the financial crisis.

The use of swaps, futures, forwards, and other derivative instruments have enabled investors to take on far greater exposure relative to their capital, and to greatly increase the potential for loss.

Market Stability and Highly Leveraged Institutions

Let me make it clear that the losses or gains by large financial market participants should not be a concern to regulatory authorities. Nor should the positions taken by individual market participants normally be of any concern. Speculators or investors, in essence, buy low/sell high or sell high/buy low, thereby providing liquidity to markets. However, there are two situations in which the very large positions taken by highly leveraged institutions are of particular concern to regulators.

The first situation is when the highly leveraged institutions taking very large positions are overwhelmed by market forces. As the case of LTCM has illustrated, highly leveraged positions can pose serious risks to systemic stability even in the large and established markets of the developed economies. As the highly leveraged institutions are, for circumstances they have not factored into their mathematical models, forced to unwind their very large positions, particularly against the background of highly volatile and illiquid market conditions, the credit losses of institutions providing the highly leveraged institutions with funding can be huge. The rapid de-leveraging of large positions by highly leveraged institutions is also highly contagious in that it in turn exacerbates volatility and reduces liquidity not only in the markets concerned, but also in other markets. The rapid de-leveraging of the short yen positions by the hedge funds in October last year is a good example of the volatility that can result. The yen strengthened by 11% to 111 over a couple of days. Such volatility affects the positions of yet other highly leveraged institutions and their counter-parties providing them with credit. The potential for market dislocation and the systemic risks this posed were so serious that, as you all know, last September the Federal Reserve Bank found it necessary to broker an unusual package by a consortium of banks to rescue LTCM.

The second situation is when the smaller markets are overwhelmed by the forces of the highly leveraged institutions. Not only does this raise serious concerns on the risk to systemic stability, it also undermines the integrity and efficiency of the markets. By virtue of their sheer size and aggressive trading strategies, the highly leveraged institutions, through their agencies, who usually also provide them with the credit, and possibly also ride along with them, often use their market power to influence the prices in smaller markets. Almost always an attack on a currency in Asia starts late on a Friday afternoon when the domestic markets in Asia are thin and when the international currency markets in London and New York open for business. Almost always a succession of big sell orders is placed for execution in a short period of time. And almost always the banks, when asked, say that they are executing those orders on behalf of their customers, whose identity and purpose cannot be disclosed because client secrecy is sacrosanct. And all this is supported with an immaculately timed commentary of gloom and doom. Some are more objective than others, but regrettably the impression one gets, particularly as a regulator, is that they are aimed at generating undue pessimism and panic, and consequent sharp and widespread movements across the currency and other related financial markets in favour of those behind the attacks.

Most of the activities of the highly leveraged institutions are carried out through the OTC markets, which are very opaque. Unlike organised exchanges, OTC markets are subject to little, if any, transparency or regulatory requirements, raising the risk of price ramping, collusion and other misconduct.

International Financial Architecture: International Co-operation for Reform

So what can be done about all this? Following the outbreak of the financial crisis, various international forums and multilateral financial institutions have devoted a great deal of effort to improving the stability and functioning of financial markets. Working group after working group has been formed to look into specific issues. There were the three G-22 working groups, the working

group under the Basle Committee on Banking Supervision, the two transparency and disclosure working groups under the Committee on Global Financial Systems, and now the three working groups of the G-7 Financial Stability Forum to be formed. And I should not forget the very useful work done by the IIF, and by other forums in this region. Many helpful reports have been prepared, including the two reports by the IIF released in March this year on risk management and on transparency in emerging markets finance, all of them produced in a highly co-operative atmosphere. I welcome in particular the Institute's readiness to work with relevant public sector bodies on appropriate disclosure for private financial institutions active in the international capital markets. I am sure this international co-operative spirit, not only among international financial institutions, national finance ministries and central banks, but also with the private sector, will in the end produce helpful blueprints for action. But this process can take too long. There is always the risk that when the dust has settled the initiative and enthusiasm, dare I say, on the part of those less affected by the crisis, may be stifled. There is also the risk that the plight of those who have been seriously affected by the crisis is not given the attention it deserves, simply because they do not have an adequately representative voice on the issues at hand at these international forums.

There is no lack of ideas, but they need to be translated into actions sooner rather than later. Let me take this opportunity to outline three broad approaches mooted at different forums and supported by us. The first approach involves enhancing the transparency of markets. Timely and reliable information relevant to decision making by market participants as well as by the regulatory authorities is crucial to the effective functioning of a market. It is thus important that there should be an adequate public disclosure framework to provide information that is necessary for counter-parties, creditors and investors to assess risks properly. Not only should increased transparency be promoted in markets trading products in an established exchange. It is also perhaps time to consider whether some suitable form of transparency requirements should be imposed in OTC markets. This is not an easy task, but I believe that with earnest international co-operation, we can achieve meaningful results. Although a delicate balancing act is required, I am confident that this is possible without imposing heavy reporting burdens or infringing too much on proprietary information of individual institutions. In this connection, the proposal by Germany for an international credit register is attractive. The register could collect information on the exposures of international financial intermediaries to single counter-parties that have the potential to create systemic risk.

For the public sector, the tasks include developing still higher standards for macroeconomic and financial data in emerging market economies, and promoting transparency in the reporting of their holdings of foreign reserves. Greater transparency in the operations of international financial institutions, such as the IMF, is also being pursued.

The second approach involves designing an appropriate form of oversight of highly leveraged institutions. The Basle Committee's report on Banks' Interaction with Highly Leveraged Institutions recommends indirect regulation in which banks should adopt more prudent policies on the assessment, measurement and management of their exposure to highly leveraged institutions. Other tools of indirect regulation could include the imposition of capital charges on lending to such institutions, raising margin and collateral requirements, and so on. While such indirect regulation, through creditors, should clearly be supported, we need to satisfy ourselves that it is an adequate safeguard against the highly leveraged institutions causing the type of systemic problems in smaller markets when their activities overwhelm these markets.

The third approach involves international co-operation to tackle regulatory arbitrage. As industrial and emerging countries continue to strengthen their own regulatory standards, financial market participants may relocate their operations to offshore financial centres to take advantage of relatively lax regulatory standards. It is thus important for offshore financial centres to strengthen their supervisory systems and standards. To encourage these centres to comply with international standards, various measures could be considered. For example, higher risk weights could be applied

to counter-party transactions for banks doing business with a financial entity operating out of an offshore jurisdiction that does not comply with Basle Core Principles.

Conclusion

Taken together, the three approaches could result in quite an extensive overhaul of the international financial architecture and a great deal of co-ordination on the international front. This is no easy undertaking, and the nature of the problem means that the process of reform needs to be both comprehensive in market coverage and inclusive in the involvement of interested parties. Cross-border speculative attacks target the vulnerabilities and weaknesses of particular economies and thrive by exploiting the gaps and inconsistencies between jurisdictions. It is therefore essential that emerging markets, and not just the big industrialised economies, are involved in the reform process. Emerging markets have been most affected by the volatilities of the last couple of years, and their experience is crucial for the formulation of workable policies: they have a different perspective of events and different needs from those of the larger, industrialised economies.

Although reform of the financial architecture has to be done on an international basis, there is much that can also be done through regional co-operation both to help advance the reform process and to promote parallel and complementary initiatives. Regional forums, of the kind that we are engaged in today, are way of gathering views and developing consensus so that collectively we can carry more weight, and speak with a more unified voice, in the international forums. They also help to ensure, for example, that the standards and best practices formulated in an international context are workable in the context of Asia.

Regional co-operation can help give a spur to closer international co-operation by ensuring that our recent experience and our special needs as open, emerging markets are taken into account in the larger process of reforming the international financial architecture. We are a diverse region, and the crisis of the past couple of years has affected us all in different ways. But the fact that it has affected all of us underlines the need for us to work together as a region in our efforts to prevent future crises.