REFLECTIONS ON THE GLOBAL FINANCIAL LANDSCAPE[1]

Hong Kong welcomes the launch of the euro and, as a major financial centre, is well placed to contribute to the euro's development in the Asia region. The euro will add a second pole to the global currency system, which, particularly in the Asian region, has been disproportionately dominated by the U.S. dollar. Future financial stability in the Asian region depends to a great extent on the development of deep, diversified, stable and transparent debt markets: Hong Kong is taking a prominent role in this process. An Asian currency unit, which could act as a regional exchange rate anchor, although unlikely to materialize in the near future, is also a possibility that might be considered in the longer term.

Introduction

Let me say what a pleasure it is to have this opportunity to address a group of such distinguished and knowledgeable representatives of European financial markets. Given the importance of the financial sector to Hong Kong's economy, I highly value the chance to interact with gatherings such as this and benefit from a mutual exchange of views on the prospects ahead of us.

Europe and Asia — Wheels of Fortune

For you, of course, the immediate future is dominated by the approach of European Monetary Union — now just a few weeks away. This must be a tremendously stimulating time in Europe as the euro comes into being after so many years of planning. There must also be a sense of vindication that, in spite of countless hurdles in the road and considerable initial scepticism, vision and determination have prevailed. The remarkable stability that we observe in European financial markets as this momentous undertaking approaches is also reassuring. Few would have anticipated that such a favourable financial climate would evolve in the aftermath of the ERM crisis earlier this decade.

Needless to say, the financial sailing has been much less smooth in my part of the world over the past year and a half. A period of rapid growth — and excessive optimism about the fundamentals underlying that growth — has been replaced by collapses in confidence, financial intermediation, and real activity. Economies accustomed to growth rates of 5 to 10 percent have witnessed equally large declines in output this year, and projections of positive growth next year are regarded as optimistic. Needless to say, much of the region is still in a state of shock over the speed and force of this dramatic turn of events. At such times, it is difficult to focus on the longer-term challenges that Asia must be prepared for when the current difficulties are behind us. But Europe's recovery from the earlier period of crisis should give us confidence that there is indeed light at the end of the tunnel, although it may seem dim at the moment.

Hong Kong has, of course, been dramatically affected by the regional turmoil. Output has contracted sharply this year, property prices have fallen to half their peak levels, and unemployment is rising. These adjustments have been wrenching, and they are likely to continue in the period immediately ahead. But there are also encouraging signs of renewed confidence, and the adjustments that are now so disruptive should, we believe, set the stage for a return to growth later next year. I also believe that Hong Kong is well placed to take advantage of the recovery that will undoubtedly come in Asia, particularly given that our financial sector has proven well-equipped to weather the worst post-war financial crisis the region has known.

1 This is the text of a lecture by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Institut Etudes Bancaires et Financière, in Paris on 8 December 1998.

The Global Financial Landscape

In this spirit, I would like to look beyond the current difficulties to the opportunities presented by the changing global financial landscape. Most immediately, the introduction of the euro is an event that we in Hong Kong welcome given our tradition of adapting to change and innovation. After discussing **what the euro means for Hong Kong**, I would like to share with you my thoughts on some broader issues the Asian crisis has raised. There has been much **market dislocation** that has surprised all of us, beyond explanation on the basis of economic fundamentals, requiring unconventional and certainly controversial responses in the defence of national financial systems. The situation is so serious that it is now widely recognised that the design of the **international financial architecture** needs serious reconsideration, along with the exchange rate arrangements that underlie trade in goods and capital. This in turn has implications for the design of the **global currency system**, with interesting long term possibilities for Asia, drawing on the experience of Europe. Meanwhile, as an exceptionally open economy in a volatile region, Hong Kong has a strong stake in ensuring that the global architecture is up to the task. In addition, the Asian crisis forces us to reconsider weaknesses in the **financial infrastructure in our region**, and the steps needed to prevent renewed turmoil.

What the Euro means for Hong Kong

Let me start with the introduction of the euro. Your attention must naturally be focussed on internal adjustments needed to ensure the euro functions smoothly. But I am sure you are also keenly interested in the promotion of the euro and euro markets outside of Euroland, to facilitate effective global financial intermediation. I can assure you that Asia, though geographically distant, shares this interest, and, notwithstanding our preoccupations in tackling financial turmoil, is observing closely and assessing carefully the implications of the euro in a world of borderless financial markets. Hong Kong's interest is particularly strong. As a modern and forward-looking financial centre, we can only benefit from the innovations that the euro will bring forth. Hong Kong has already developed unparalleled linkages with European markets, via our existing ties with European securities clearing and settlement systems, and in particular our strong linkages with your CEDEL and Euroclear systems.

These ties should obviously be extended to our respective payment systems and the objective must be to ensure that payments of financial transactions involving the euro and carried out in the Asian time zone could be made efficiently and with the minimum of risk — especially without Herstatt risk. There are interesting possibilities that can be explored and we would like to do so sooner rather than later. We recognise of course the golden rule that no central bank shall grant credit in a currency other than its own, consistent with the policy statement issued by the European Central Bank last month on euro payment and settlement systems located outside the euro area. We in Hong Kong have a state-of-the-art Real Time Gross Settlement System built in 1996 and we look forward to establishing a linkage with the TARGET system that will soon come into operation in Europe.

Beyond these technological linkages, Hong Kong has, by far, the largest presence of European banks in Asia, with 37 institutions in active operation. This deep involvement of your banks in Hong Kong testifies to our strengths as a financial centre — including transparency, sound oversight, and world-class prudential supervision. Indeed, despite the turmoil in Asia, our banking system remains soundly capitalised and profitable. As the offshore euro market deepens, as it surely will, these fundamental strengths of Hong Kong's markets will position us well to take advantage of the new opportunities that will be created.

These linkages will also provide a robust base for the growth of financial flows between Hong Kong and Europe. In terms of flows to our region, Hong Kong's unparalleled role as a gateway to China — and Asia more generally — represents an attractive channel for the investment of Europe's huge pool of capital. Hong Kong's capital markets themselves will also become more accessible with the pending link between the Frankfurt and London stock exchanges — where Hong Kong companies are very actively represented. In the other direction, the euro creates significant opportunities for stimulating financial flows from Asia to Europe. Asia possesses enormous foreign exchange reserves, the vast majority of which are held in U.S. dollar assets. The creation of a deep and liquid market in euro-denominated assets will provide an attractive opportunity to diversify these foreign exchange holdings. Hong Kong will be actively looking at this possibility, and our strong fund management and foreign exchange capabilities should facilitate the diversification of reserve holdings by other regional central banks.

Macroeconomic factors will also have an important bearing on how the post-euro financial system evolves. As you are fully aware, there is an ongoing debate as to whether the euro will be a "strong" or a "weak" currency. I see little chance of the euro being a systemically weak currency given the high credibility established by monetary policy makers in Europe and the strong institutional structure underpinning the new European Central Bank. Of more concern, I think, than the strength of the euro, is the volatility of major exchange rates in the period ahead. Excessive swings in value, even if the underlying trend is strong, can be extremely destabilising, as Japan's experience has shown. Dramatic swings in the yen over the past several years have been highly disruptive, both for Japan itself and the Asian region more generally. The dislocations have been great even though the share of external trade in Japan's GDP is not much larger than that of the new euro area. Hong Kong has a particular interest in exchange rate stability given our status as a small and very open economy with an exchange rate link to a major currency.

What are the preconditions for currency stability? The first, of course, is that the fundamentals be sound. Here, as I have already mentioned, there is every reason to believe that European policies will be up to the task. You have established robust monetary institutions, and fiscal discipline will be guided by the Stability and Growth Pact. The second — and perhaps more important — precondition is that the global financial framework be up to the task of ensuring that sound fundamentals are reflected in appropriate exchange rate values. Here I am less sanguine. We have witnessed huge swings in exchange rates, both in the values of the major currencies and of the smaller Asian currencies, that appear inconsistent with any reasonable view of fundamentals. Have changes in Japan's fundamentals justified a 20 per cent appreciation of the yen over the past few months? Can changes in Indonesia's fundamentals explain, first, a 75 per cent decline in the rupiah when the crisis hit, and then a rough doubling in its value since late summer?

Market Dislocation

I think it is clear that financial markets are subject to speculative forces and, at times, attacks of pure panic that can create market dislocation and take values far away from economic fundamentals. Human nature being what it is, fear and greed are more likely to motivate behaviour than sober analysis in times of turmoil. Asia, particularly those with open markets, has been greatly affected by these forces. Hong Kong was not spared, in spite of our very sound fundamentals — consistent budget surpluses; a well-regulated and highly capitalised banking sector; open and transparent financial markets; a high savings rate; and flexible labour markets. Hong Kong's trade linkages with the ASEAN countries, where the turmoil started, are also rather small. Of course, some effect on our markets from the turmoil elsewhere would still be natural. But the attacks we experienced, most recently in August of this year, have had little if anything to do Hong Kong's fundamentals — it does not require sophisticated economic analysis to conclude that Hong Kong has negligible direct linkages with Russia, for instance! But effects far from our borders have triggered speculation in our markets that has gone far beyond anything justified by the fundamentals. If carried to extremes, though, such attacks have the potential to be self-fulfilling through the distortions they introduce throughout the economy.

In August, we were faced with a situation where co-ordinated attacks were being launched in an attempt to manipulate our markets to the advantage of sophisticated speculators. By intensively selling Hong Kong dollars over a short period, speculators had become aware that they could temporarily drive up interest rates under our currency board arrangements. While these actions posed no threat to our exchange rate link — which is backed by enormous foreign reserves and strong public support — the speculators observed that higher interest rates would put downward pressure on stock prices. By pressuring the currency and also selling stocks short, they could realise a profit even if there was little chance of breaking the exchange link.

The increasing intensity of this "double-play" activity formed the background to the Government's controversial operations in equity markets in late August. We purchased stocks at that time to ensure that speculators would not profit further from this type of manipulation of Hong Kong's markets. Let me assure you — there was (and is) no intention to establish or defend a given level of equity prices. Nor does the Government want to play a role in corporate decision making in Hong Kong. Indeed, the stock portfolio has since been turned over to an independent body with wide representation, to be managed in a neutral and transparent manner. That body may well decide that current equity holdings are excessive in achieving longer-term public investment objectives, and the portfolio could be reduced down the road. But any such action would be designed to have a minimal effect on the market.

I mentioned that this operation was highly controversial at the time — understandably so, to those not familiar with the technicalities of Hong Kong's markets. I would note, however, that some of the initial sceptics have reconsidered their views, and there is now a clearer understanding of the Government's motivation. Furthermore, important steps have been taken to improve our system to protect it against a recurrence of such activity. Stock exchange trading rules have been tightened, and we have introduced several adjustments to our currency board system to reduce the sensitivity of interest rates to temporary speculative pressures. I believe these measures are significant improvements that will contribute to the stability of our markets. And activity has indeed been calmer in recent months, although external developments have undoubtedly played an important role.

Reform of the International Financial Architecture

There remains, though, the issue of how to better regulate the volatile capital flows that contribute to such market instability. Thoughtful observers are increasingly questioning the parallels often drawn between the benefits of unrestricted trade in goods and financial capital. The evidence is overwhelming that free trade in goods has supported tremendous economic growth — the development of both Europe and Asia testifies to this. Financial flows are far more volatile, however, and more easily subject to bandwagons, irrational exuberance and pessimism, and speculative overshooting. These phenomena are not unique to developing markets. The asset price bubbles in Japan and some other major countries in the late 1980s and the 1992 ERM crisis are notable examples. With the Asian crisis still playing out, the search has intensified for better mechanisms to channel and monitor international capital flows. Not only do borrowers want a more stable environment — we must be struck by the fact that some of the most aggressive of the speculators, such as George Soros, recognise the need for change.

What are the priorities from Hong Kong's perspective as an international financial centre? The **first** must be improved information and disclosure. Economic theory tells us that markets function more efficiently with more information. Financial markets, surely, are no exception. From a practical perspective, there can be no doubt that the Asian problems were allowed to build up because of a lack of information about the full financial picture, both in terms of the destination and source of the funds. In an ideal world where all such information was freely available on a real-time basis, I believe the problems would have been contained at a much earlier stage. But I am not a utopian. Progress will require time. Important steps toward greater transparency are being taken in several Asian countries, however, and I am glad to say that Hong Kong serves as an example in this regard. We must also rethink the need for disclosure on the investor side. Clearly this is a delicate issue, but the virtual complete lack of information of the activities of huge global institutional investors poses risks to all concerned — other investors, lenders to these institutions, and ultimate borrowers. Initiatives are underway to study how improvements can be made, which Hong Kong fully supports. We have a strong desire, however, that the outcome reflects a broad consensus on the disclosure practices that would satisfy the needs of both borrowing and lending countries.

More information can help to reduce excessive risk taking, but it is no guarantee that behaviour will be prudent. The **second** priority must be improved prudential oversight of capital flows, especially when they have the potential to magnify existing distortions. The approach taken to capital account liberalisation in some Asian countries was clearly inappropriate given weaknesses in domestic financial sectors. Lax supervision, weak accounting standards, close relationships between lenders and borrowers, and inadequate prudential safeguards all interacted with "hot" capital inflows to fuel the crisis. I am happy to say that Hong Kong's experience with these issues in the early 1980s prompted us to take corrective measures some time ago. As a result, our financial sector has weathered the storm well. Again, developed countries are not immune from regulatory weaknesses. The problems at Long Term Capital Management underscore the potential for cracks even in well-developed regulatory frameworks to suddenly appear, with systemic consequences. So efforts must be made to strengthen global prudential and regulatory frameworks, an effort that I see as being supportive of the general trend towards a more liberal financial environment.

Thirdly, we must consider how domestic restrictions on anti-competitive behaviour in financial markets can be applied in an international environment. We have seen clear evidence, at times, of collusion and co-ordination in attacks on Hong Kong's markets. There exist rules against the cornering of markets and other types of manipulation in domestic financial markets. For the same reasons that these activities are not tolerated domestically, thought must be given as to how to apply these principles to cross-border financial speculation.

Many of these prudential and regulatory issues are under active discussion in various international forums. There are G7, G10, G22, G26, EMEAP, APEC, BIS and of course the IMF. I fear, however, that there are too many of these groupings which quite naturally also focussed on the appropriate form of this international effort that the substance of the discussion may suffer as a result. There is clearly a need to get on with the work. We should not let this matter drag on for too long. The danger is that individual economies — particularly the small open economies — having to defend their financial systems against the onslaught of unrestrained international capital may be forced into taking unconventional and controversial action that may involve downside risks to the healthy development of an open global financial system.

The Global Currency System

We must also be concerned about macroeconomic issues, and in particular the broad shape of the global currency system in the post-euro environment. Up until now, the U.S. dollar has played a dominant role in global trade — a role disproportionate to the size of U.S. trade flows. With the introduction of the euro, a second pole of the global currency system should become more firmly cemented, which would serve countries in Europe and the Western Hemisphere well. But the third pole of the global currency system has yet to be defined. The yen, for instance, has not assumed a major role as an anchor in Asia, in spite of Japan's strong trade and financial ties in the region. As a result, fluctuations in the yen's value have caused large and disruptive swings in effective exchange rates and financing costs of trade partners. Yet Japan's present economic and financial difficulties make it unlikely that the yen's role will expand in the foreseeable future. While Hong Kong has been well served by a solid link to the U.S. dollar, supported by sound policies, loose and poorly supported commitments to the dollar have proven disruptive for other countries. Thus, the Asian region as a whole lacks a viable exchange rate anchor.

Serious consideration must be given to this issue, particularly when crisis conditions subside. Our peg to the U.S. dollar has served Hong Kong well, and continues to enjoy a high degree of public support. I have every reason to believe that Hong Kong's financial markets would have been more — not less — volatile in the absence of the peg. Of course, our system is supported by huge reserves, prudent fiscal policies, and firm regulatory oversight.

But other countries could similarly benefit from links to key currencies when they are in a sufficiently strong position to make such links fully credible.

Down the road, one might even want to consider the introduction of an Asian currency — something like an "Asian Currency Unit" — that could form an anchor currency for the region. Such a currency would have the advantage of reflecting the strong trade linkages in the region. It could also help to address problems of intermediating financial resources within Asia. At the moment, Asian central banks invest massive amounts in foreign securities, primarily U.S. dollar assets, only to see volatile funds flow back to the region from overseas markets. By investing reserves directly in Asian financial assets, this type of recycling through developed markets could be reduced.

I have no illusions about the obstacles to the creation of such a system. An institution would be required to administer it, the politics of which would be very complicated. Monetary and fiscal policy co-ordination would be needed throughout the region, involving countries at different stages of development, etc. You are well aware of these issues having witnessed several decades of European integration. So this is an idea that can only be considered in the fullness of time. The introduction of the euro is the culmination of 50 years of post-war European integration — it is unlikely that Asia will, at this stage, develop great enthusiasm in the European model. But I believe it is useful to throw the discussion open at the intellectual level, in part as a means of stimulating greater dialogue and co-operation within the region to facilitate the more immediate agenda.

Asian Financial Infrastructure

A final lesson of the Asian crisis involves the functioning of our financial markets. The excessive reliance in Asia on short-term financing from overseas lenders through weakly regulated banking systems reflects the lack of deep and diversified debt markets in the region. This problem, again, is not unique to Asia, but is one that must be addressed in order that financial development keeps pace with the strong underlying growth in other sectors of the Asian economies. Japan's current problems illustrate the risks of letting development of the financial sector fall too far behind industrial growth. A key priority is the need for deeper, longer-term, more stable, and more transparent debt markets in Asia. Too large a share of Asia's financial resources has been recycled through overseas markets, with a consequent loss of contact and information flows between borrowers and lenders. We need to establish local securities markets that bring both sides of the market into more direct and longer-term relationships. The global trend in this direction has largely bypassed Asia, and we need to work hard to correct this problem.

The basic problem is familiar — investors, especially institutions, have little appetite for placing funds in markets that are not already deep and liquid. Yet individual issuers, by themselves, are not in a position to create deep and liquid markets. At the same time, it would be in the collective interest of both borrowers and lenders to have financial instruments that leave them less exposed in terms of currency and maturity mismatches. So some help will be needed at an official level to encourage the appropriate conditions for market development.

Hong Kong is taking a leading role in this process. Among other things, we are leading an APEC initiative on bond markets in the region, and will examine key impediments to their development. We plan to bring together market practitioners, government agencies, and international financial institutions to tackle in a consistent way the roadblocks to developing Asian debt markets. There are several issues to be addressed. The first is the lack of an established credit rating system for most companies in our region, given their relatively small size. Here, the issuance of guarantees by governments or international financial institutions could play a useful role in the initial stages of market development. The Miyazawa Initiative provides a welcome example of such a framework, and we hope that it will stimulate more active bond markets. There is also a lack of benchmark yield curves for pricing debt — an issue that we have gone some way to addressing in

Hong Kong through our Exchange Fund bills and notes program. But the traditional absence of large budget deficits in most of the region has limited the development of government bond markets, and we will have to think further about how to overcome this problem. There are also issues of rationalising the tax treatment of debt. Ironically, preferential treatment is often accorded to bonds issued by international agencies that have no intention of recycling the funds back into the domestic economy, creating an unequal playing field for domestic corporate issuers. We are actively looking at this issue in Hong Kong, but regional co-operation on taxation may be required to establish a fair and consistent system. Finally, the regional infrastructure needs to be improved for the clearing and settlement of such debt. Hong Kong's systems are already the most advanced in the region, but we are looking at ways to link together other systems across Asia in the form of an "AsiaClear" network.

From this long list you will see that we have our work cut out for us! But the task is an important one, both for Hong Kong and the region as a whole. No doubt, similar obstacles were faced in the initial stages of developing many successful financial markets, so we must not be discouraged. Again, the euro comes to mind as a project that faced innumerable hurdles that were overcome through determination and persistence. We hope to emulate your success.

Conclusion

My talk has covered a lot of territory, both figuratively and literally. In Europe, your immediate concern is the smooth introduction of the euro, while in Asia the question is how to restore financial stability to support sound growth. Hong Kong has a strong interest in both issues, as our evolution as a financial centre hinges on the healthy development of world financial markets. Hence our interest in questions of the global financial architecture, and how to adapt it to ensure that openness and integration bring lasting economic benefits. We must be realistic, though, in recognising that Hong Kong's voice in these issues is only one of many. Progress will depend critically on active support from other countries with established financial centres, including your own. So I hope that Europe will remain strongly engaged in the process of improving the operation of global markets, which I believe to be fully complementary to the task of ensuring the smooth and successful introduction of the euro.