HONG KONG AND ASIA: FROM CRISIS TO OPPORTUNITY[1]

One positive outcome of the Asian financial crisis is that economies throughout the region are taking important steps towards reforming their financial systems. These reforms should not only make Asia's financial systems more resilient in the face of future financial crisis but also help them to exploit new opportunities in the longer term. This speech discusses institutional reforms in various parts of the region both in response to the Asian financial crisis and in the context of three longer term forces for change: globalisation, technological advance and changing customer needs.

I am honoured to have this opportunity to address what promises to be an important and productive conference. The conference programme includes prominent speakers from within the region and beyond, most of whom are closely engaged in the process of bringing the Asian economies out of crisis and towards recovery. When, some months ago, the organisers first planned a conference around the theme of recovery, it was still by no means clear when that recovery might be expected. Now, nearly two years after the Asian financial crisis first broke, the signs are that the region has passed through the worst and that it is now looking towards better times. The pace of recovery will vary from one economy to another. The continuing uncertainties in Japan, the region's largest economy, also suggest that the recovery might be less robust than we would wish. At the very least, however, we have seen significant upturn in the financial markets of the region ahead of the predicted return to growth over the next year or so in most economies, including those worst hit by the crisis.

The theme of this conference is <u>strategies</u> for recovery. It is, I think, important to lay stress on the first of these words. We should not be taking recovery for granted, as a phase of economic activity that follows crisis and recession as inevitably as day follows night. Rather, we should be looking at how we can promote conditions which will not only foster a full and speedy recovery, but which will also help ensure that recovery is balanced, healthy, and above all sustainable: that it does not, for example, take the form of yet another bubble, which could be the prelude to yet another crisis. This is why the focus on active strategies, rather than on passive adaptation, is necessary. I should like to go a stage further, and suggest that we should not simply be devising strategies for recovery. We should also be planning ahead, rethinking our approaches to economic and financial problems, and questioning our assumptions in a way that will help us respond to the challenges and opportunities that lie beyond recovery. The Asian financial crisis has perhaps encouraged us to look at issues affecting our success as a region more urgently and energetically, and that may not be a bad thing. But, given the forces for change in the world today, they are issues that need to be addressed anyway, even had the crisis never taken place.

Having seen the press reports of my various speeches over the past few months, you will probably be expecting to hear another speech about the evils of hedge funds and the risks of volatile international capital flows. But I shall leave the hedge funds alone this time, as they meet large scale redemptions, other than to say that the Nemesis of those who play the market is often the market itself. I nevertheless hope that this time around they will not be forced into deleveraging to the extent of again creating market dislocation and threatening systemic stability. And I shall be brief about the urgent need for reforms to the international financial architecture to cope with volatile international capital flows. I shall come

1 This is the text of a keynote address delivered by Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, at the Sixth Annual Far Eastern Economic Review Conference on 16 June 1999.

back to this only towards the end of this speech, to emphasise that such reforms are a necessary part of the strategy for recovery, if sustainable growth is to follow. My main focus here is on what needs to be done by individual economies in the region – and on what is being done – to deal with the weaknesses exposed by the Asian crisis through institutional reforms and other measures. Using Hong Kong's current review of its banking sector, I shall also explore strategic approaches to the opportunities and challenges posed by globalisation, technological advance, and changing public needs.

Addressing the weaknesses exposed by the Asian financial crisis

The multiple causes of the Asian financial crisis are too complex to be conveniently described here. I have no doubt the sessions in this conference dedicated to individual economies will go into these causes in some detail. There are, however, some factors in the crisis that are common to the affected economies, albeit to varying degrees. These factors converge on the weaknesses and vulnerabilities in the financial systems of many Asian economies, and particularly in the bad habits formed by financial institutions. For example, some banks had a tendency to incur excessive risks by being overly dependent upon short-term funds to finance long-term investments that were of doubtful viability. Excessive lending fuelled asset price inflation, while the corporate sectors over-stretched themselves by engaging in risky or unproductive projects. Poor risk management on the part of banks meant that alarm bells did not ring until the situation got out of hand. On top of all this, ineffective banking supervision, political interference, and a critical lack of transparency prevented disciplinary mechanisms from operating as they should. To make things worse, both the banks and the corporates were taking excessive currency risks by borrowing in foreign currencies, which had much lower interest costs than domestic currencies, to fund projects that could only generate income in domestic currencies. Implicit government guarantees on exchange rate stability eroded awareness of the risks arising from currency and maturity mismatches between the banking and corporate sectors. The phenomenal increase in international capital flows that helped fuel this process added powder to the keg, so that when disaster struck it was all the more explosive.

Volatile capital flows and defects in the international financial architecture have been an important component of the crisis, but it is clear enough from the summary I have given that many of the problems are closer to home and institutional in nature: lending excesses, poor risk management, political interference, weak supervision, lack of transparency, and so on. Solutions to these problems are within our grasp, in the sense that they are not so dependent on international consensus: they are also essential if the international reforms necessary to ensure global stability are to be effective. No matter what forms of international monitoring and regulation might arise out of the discussions that are currently in progress, domestic financial systems will remain the basic building blocks of the international financial system for the foreseeable future, particularly in a region as politically and economically diverse as Asia. If the Asian financial crisis has taught us anything, then it must surely be that the globalisation and liberalisation of markets require stronger, not weaker, domestic systems.

It is therefore very encouraging to see, as a positive outcome of the Asian financial crisis, that economies all over the region are taking important strategic steps towards reforming their financial systems. The most notable initiatives are taking place in Malaysia, Korea, Indonesia and Thailand, where extensive programmes are in progress to restructure and recapitalise banks. In Malaysia and Korea, for example, these programmes include the establishment of asset management companies as special purpose vehicles to purchase non-performing loans from banks. They also include schemes to restructure corporate debts. A number of countries are making substantial reforms to their supervisory systems to improve prudential regulation and enhance transparency by mandating better disclosure standards. There should be no illusion about the scale and difficulty of these projects, or of the pain that will by necessity accompany them. But the end result of these various reforms will be to leave Asia's financial systems in a much healthier condition and to make them more resilient in the face of future financial crises and more capable of exploiting new opportunities.

The Asian financial crisis and Hong Kong

It may be tempting to say that, had these institutional reforms been extensively in place a few years ago, the Asian financial crisis might never have erupted. I am not convinced of this. While it is perhaps reasonable to say that the scale might not have been so great, the Hong Kong experience has suggested that even sound systems are not proof against external shocks. We do not claim to have a perfect system, and a conference of this nature is not the place for complacency, but I think it is at least fair to say that our system is free of the worst of the problems I have outlined. In Hong Kong we were fortunate to have in place prior to the Asian financial crisis a sound regulatory infrastructure, strong and well capitalised banks, disclosure standards comparable to the best in the world, and effective liquidation laws. Hong Kong's banks also have, learning from the difficulties of the early eighties, established a tradition of prudent and conservative management, supported by a Hong Kong Administration that does not exercise political influence on bank lending. Further, in contrast to the implicit, but ultimately unsustainable exchange rate guarantees, or exchange control measures, elsewhere in the region, we have an explicit linked exchange rate system, maintained through a strict rule-based currency board system and fully backed by some of the largest official reserves in the world, for a currency that is required by law to be freely convertible.

The resilience of our banking system and the stability conferred by our linked exchange rate system helped to prevent a meltdown in Hong Kong's financial system. That is not, however, to say that the Asian financial crisis did not expose weaknesses and vulnerabilities in Hong Kong. The weaknesses were associated in many ways with the euphoria that had affected other parts of pre-crisis Asia. The vulnerabilities arise both from Hong Kong's susceptibility, as an externally oriented economy, to external shocks and, ironically, from the robustness of its exchange rate system. First, various problems and imbalances in the system came to light when confidence in the region plummeted. Foremost among these was the rapid escalation in asset prices prior to the crisis, most notably in property values, which was beginning to undermine Hong Kong's competitiveness. Even before the crisis erupted, it was apparent that a downward adjustment was inevitable.

The second problem arose in the nature of Hong Kong's currency board system, which, by its very transparency and predictability, was susceptible to speculative attack once the crisis had erupted. The form which these attacks took, and the climax of last August have already been dealt with in detail elsewhere. The immediate effect of these attacks was a triggering of sharp interest rate adjustments through the currency board mechanism of a magnitude never experienced before in Hong Kong. Notwithstanding the fact that the Hong Kong economy operates with a relatively low gearing, as evidenced in the high savings rate, the extreme interest rate volatility translated into substantial falls in both stock and property prices and in extensive pain for the community as a whole, over and above the pain already being experienced through economic adjustment. I am glad, nevertheless, to report here that the technical improvements to the currency board system introduced last September, together with our emphatic demonstration last August that we do not intend to take speculative attacks lying down, have since helped to stabilise the markets. The risk of such attacks leading to market dislocation and overshooting, and possibly a meltdown of the financial system has been greatly reduced.

Thirdly, while Hong Kong's banking sector as a whole has withstood the crisis extremely well, the Asian crisis has highlighted certain problems in risk management. The crisis demonstrated the importance of strong balance sheets that can cope with the large swings in interest rates resulting from external shocks. With the sudden plunge in asset values, it also underlined the need for effective management of credit risk. Despite the generally high standards of banks in Hong Kong, the crisis revealed this to be an area where lessons can be learned. In particular, it confirmed that banks have placed too much reliance on asset-based lending. The emphasis in credit decisions on collateral rather than on analysis of cash flows and on the underlying financial viability of the borrower left banks heavily exposed to fluctuations in asset prices.

The problems that have recently arisen with Mainland enterprises are perhaps not linked directly with the larger Asian crisis, but they have added to the pressures on Hong Kong's banks and have revealed a tendency among some banks to base their lending decisions on the reputation of their counterparties and on implicit sovereign guarantees. It should be pointed out here that the practice of name lending is not confined to Asia, as some international commentators would have us believe: the LTCM episode demonstrated that, even in a mature and developed system, banks can place too much reliance on counterparty reputation, and, in the process, can compromise their normal due diligence and credit standards. For banks in Hong Kong, the liquidation of GITIC and the financial difficulties of GDE have overturned the assumptions on which banks based their lending to Chinese borrowers. Looking to the future, banks will need to lend on the intrinsic financial strength of these borrowers, rather than on the expectation of government support. In the long run, this must be a good thing. In the short term, however, the disruptions have added to the stresses of the larger Asian crisis.

Challenges and opportunities beyond the crisis

My focus so far has been on the problems on Asia's immediate horizon that need immediate attention through supervisory action or institutional reform. Solutions to these problems will, of course, have long-term benefits that will go far beyond merely fixing the present crisis. But there are also more fundamental longer-term forces which are shaping and re-shaping the financial landscape and which will have an important impact on how Hong Kong and other financial centres in the region develop into the next century. It is important that we take the necessary preparatory measures to ensure that this impact is a positive one, and that we put ourselves in a position to get the best advantage of the changes that lie ahead.

What, then, are these longer-term forces? I think we can single out three broad, interdependent trends: globalisation, technological advance, and changing customer needs. <u>Globalisation</u> means that, as societies and their economies become more open, financial markets become international in their scope, and financial service providers become global in scale. The dismantling of barriers, the availability of low-cost, high-speed transportation, and the dramatic impact of applied technology have facilitated a massive growth in international trade and capital flows. More and more companies are becoming transnational in their organisation and outlook, and they naturally look to support from financial institutions that have more global reach, expertise and influence. Wholesale and investment banking are already globalising quickly, since many of their products and services are already global in nature. Even in personal financial services, which are primarily domestic-based, the indications are that the nature of business will become more global over the next decade: in fact, the process is already in train with the development of global brand names like Citibank and HSBC. The implications for financial institutions are clear enough. Globalisation offers new opportunities for financial institutions to expand overseas, but it also brings new competition from institutions based in other countries. For policy-makers, the challenge is in the complex task of ensuring that regulatory frameworks continue to be effective as traditional boundaries melt away and in helping financial markets benefit from the diversity and innovation that open competition can bring without sacrificing stability.

<u>Technological advance</u> includes both innovation in financial services and the declining cost and increased accessibility of information technology. Technological advance is an important facilitator of globalisation and a force of change in its own right. Technology makes it possible for businesses, and particularly financial institutions, to be managed on a global scale. Computer technology has made it possible to produce, sell and service financial service products such as complex derivatives, securitised papers and other types of investments. It also allows financial services to be accessed through a growing range of channels, including ATMs, the telephone, the Internet, debit cards,

smart cards, in addition to the traditional branch system. Technological advance is a continuous process, and the challenge lies in harnessing the skills necessary to extract the benefits from innovation in an economical and flexible way.

Changing customer needs both influence, and are influenced by, technological advance. Retail customers have become more involved in their own investment planning and more ready to shop around. For this reason, they also demand a broader range of products and services at more competitive prices through more convenient channels. Corporate customers have not only become more performance-oriented, but are also demanding both low-cost financing and world-class specialist advice. Large corporations already have their own trading desks and direct access to the market that allows them literally to shop around the world. Suffice it to say that, in an increasingly liberalised and competitive world, businesses that do not respond to changing customer needs do not survive.

These various considerations were behind the Hong Kong Banking Sector Consultancy Study, which we commissioned last year. The Study's report contains important recommendations for the strategic development of Hong Kong's banking industry, and, in that sense, it is a strategy for growth rather than for rehabilitation. Following an extensive public consultation earlier this year, a decision on the recommendations in the Study will be made this summer. The recommendations highlight the need for change towards a more open environment conducive to competition. At the same time, they also recognise the necessity of balancing this with safeguards to ensure continued stability. In Hong Kong, which is already one of the most open economies in the world, this means removing unnecessary market entry restrictions, continuing our efforts to improve transparency, and deregulating the remaining rules for setting certain types of interest rates. To complement these proposals for encouraging more competition, the Study also recommends certain measures conducive to stability, such as clarifying the HKMA's role as lender of last resort, improving depositor protection, and introducing enhancements to our risk-based supervisory regime.

So much for the work of the policy-maker and regulator. For the banks themselves, the forces of change mean that they will have to work harder to identify and sustain business and to succeed in an increasingly competitive environment. The long-term strategies that they adopt will be crucial in determining their success in this. Some, for example, may decide to adopt the strategy of becoming 'financial supermarkets', offering a broad range of products aimed at satisfying their customers' every need. Others may specialise in a particular niche, and aim to be the best provider of the best products in that particular segment. It goes without saying that technology is the great enabler in all of this, in that it enables banks to offer their products and services in a flexible manner, while, at the same time, helping to make their operations more efficient and cost-effective. It is ironic that, although the cost of processing is declining, banks are investing increasing amounts in technology in order to compete. Rising costs, and changing demands among customers mean that banks will need to re-examine carefully the costs and benefits of the services they currently provide. The implication is clear: larger institutions will be in a much stronger position to compete. The economies of scale are hard to ignore when the cost of investment in new systems is reaching astronomical heights. One of the quickest ways of achieving economies of scale is through consolidation. Financial service providers in the US and in Europe have already taken this path, with the waves of mergers and acquisitions in recent years. Banks in Hong Kong - and, I would suggest, elsewhere in the region - must also seriously consider this option if they wish to continue competing effectively.

Conclusion

I have focused on banking reforms in this speech because banks are the most concrete and most essential units of any financial system. Banking reform, both to resolve immediate problems and to address the challenges of the future, is a vital part of the strategy for recovery, which is the central theme of this conference. There are, of course, other areas of reform that need to be pursued, whether by individual jurisdictions, within the region, or in the international community. The question naturally arises of whether the strategies currently being pursued are sufficient to prevent another financial crisis. Much of what I have said might suggest that they are: that if the reforms at the corporate and regulatory levels are seen through, Asia as a region will not only be in a good position to avoid the extreme stresses it has been through these past two years, but will also be strengthened against contagion from financial crises in other parts of the world. The fact that the extreme manipulative activities of highly leveraged institutions are currently in abeyance has provided the region with a breathing space to get on with these reforms. In the longer term further changes at the regional level, such as the development of regional debt markets that is already in progress, will bolster this resilience.

But we would be lulling ourselves into a false sense of security if we supposed that reforms at the jurisdictional and regional level are sufficient on their own. They will help towards mitigating the scale of future crises, but they will not in themselves prevent a crisis from recurring. The necessary counterpart of the reforms now being vigorously pursued within the region is reform at the global level to an international financial architecture that has been outgrown and outpaced by massive increases in the volume and speed of cross-border fund flows. The aim of this reform should be, not to place barriers in the way of these fund flows, but to provide a level of oversight and transparency that will ensure that the excessive volatilities we have recently seen are kept within reasonable bounds. There is some international consensus on what needs to be done, and I, for one, am optimistic that a breakthrough, in the form of a concrete plan of action, will not be long in coming. Our strategies for recovery in Asia must include this larger international dimension, because whatever view one takes of the exact causes of the Asian financial crisis, there is no doubt that the activities of highly leveraged institutions played an important role in provoking, spreading and deepening the crisis. Our capacity to recover, and our readiness to embrace the opportunities that lie beyond recovery depend most of all on the reforms we implement within our own jurisdictions. But the economic stability that is a necessary condition of full recovery, and our future as a community of open and outward-looking markets, require decisive action at an international level.