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## Speaking Notes for Presentation to Policy Dialogue

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- Thank you for the opportunity to participate in this very impressive forum, and in particular, in this policy dialogue.
- My presentation today is relatively low tech – I have just the one slide which sets out the three broad sets of issues I will try to touch upon.
- First, it is notable that we are here to discuss “new opportunities and advancing regional stability” ten years after the onset of the Asian financial crisis, and against the backdrop, again, of global financial market instability
  - Like Jim Wolfensohn, the last time I was in this convention centre was at the time of the 1997 Annual Meetings of the IMF and World Bank, albeit in a far less exalted role than Jim’s, and I was struck as I entered the building this morning that on that occasion much of the corridor discussion was focused on coming to grips with the potential implications of the crisis which was in the early stages of unfolding as we met
- Of course, current turbulence in financial markets is of a different nature to that of ten years ago, and triggered by very different factors – ironically, in the world’s most developed capital market.
  - Some have described the recent liquidity issues in credit markets as the first test of a model of global capitalism based on capital markets rather than on the traditional banking sector.
  - Perhaps the key question we will need to ask as these events unfold is: Will financial market arrangements which in theory are designed to diversify risk and assist in its management end up compounding, rather than muting, the real economic cost of recent shocks in the US mortgage market?
- The last ten years has also seen the region demonstrate remarkable resilience in recovering from the events of 1997-98.
  - It has re-established itself as an engine of growth for the global economy and a significant source of global savings – which may or may not be well used elsewhere in the world.
  - Sound macroeconomic policy settings have been underpinned, as others have noted, by important progress in reforming financial sectors.

- Banking sector reform in many economies has included improved risk management and supervisory oversight, and has been complemented by improvements in governance, including corporate governance more broadly.
- And, overall in the region, there is greater exchange rate flexibility.
- All of this has helped place the region in better shape to cope with any external shocks which might occur.
- And, so far, the region appears to be weathering the current market turbulence well.
  - Asian institutions' direct exposure to the US sub-prime market appears limited and small relative to total assets.
  - The region does not appear to have experienced, to anything like the same degree, the sharp increases in short term money market rates seen elsewhere.
  - Sovereign debt spreads to US Treasuries have risen, but by less than those on low rated US corporate debt.
  - And adjustments in equity and FX markets, while significant, have not been especially large compared to the adjustments associated with other historical shocks.
- Of course, regional markets are benefiting from not being at the cutting edge of securitization and lending innovations being pursued in the more developed economies – there are sometimes advantages to watching how such trends pan out elsewhere, and learning whatever lessons are to be learnt, before heading too far down the same path.
- But the importance of the structural improvements made in the region over the last decade should not be discounted – nor the importance of pressing on with this reform agenda.
- I think it is entirely right that the further development of the region's capital markets – and in particular, private capital markets – remains an important policy objective in the wake of the 1997-98 experience and the concerns about over reliance on , at that time, relatively weak banking sectors.
  - Deepening and strengthening private capital markets was a particular theme of the 2007 APEC Finance Ministers' process, chaired by Australia.
- And whatever lessons we may all (i.e. both market participants and policy advisers/regulators) eventually learn from recent events – about the impact of securitization, and asset backed securities markets, on managing and diversifying risk, the relationship between banks and their special purpose vehicles, the role of credit rating agencies, etc – to my mind, these events serve to reinforce some basic requirements of robust and efficient financial markets, namely
  - The crucial importance of a commitment to strong risk management systems and cultures within financial institutions
    - : And as part of that, the importance of a sound banking system as a crucial complement to, and foundation for, robust and efficient capital markets
  - The need for a strong and effective prudential regulatory framework, focused on core, systemically important financial sector 'promises' to beneficiaries – which in Australia

are taken to include not only those of deposit takers but also of insurance companies and pension funds.

- Effective disclosure and transparency arrangements to preserve the integrity of markets
- And trust in the quality of the underlying market infrastructure – such as insolvency laws, accounting standards, payments systems, corporate governance etc.
- These principles remain key to the regions' continuing efforts to develop capital markets which will allow it to optimise the benefits of its engagement in a globalised economy.
- Notwithstanding the impressive progress I and others have already noted, capital market development continues to lag behind reform in the banking sector (which, as implied earlier, may be a good thing right at the moment!) and progress on both varies significantly across the region.
  - One interesting observation I heard during a recent APEC workshop on these issues was that a lot of regulation and policy in the region continued to be influenced by a 30 year old mindset that the objective was to keep scarce savings at home. Circumstances have clearly changed, and so should any legacy of that mindset.
- While it is difficult to generalise, I would suggest that priority should be given to
  - Fostering a diversified investor base for corporate bonds
  - Enhancing liquidity
  - Building the legal frameworks to help transfer risk
  - And, of course, with everyone else, making sure we all learn whatever specific lessons come out of the current market developments – about facilitating accurate risk assessment, pricing and transparency.
- Let me now say something about Australia's experience with financial sector reform, a process that goes back about 25 years (essentially spanning my career in public policy), starting with the floating of the \$A in December 1983, and which has seen the Australian financial sector transformed from one which was inefficient, inward looking, and vulnerable to external shocks, to one which is now open, efficient, dynamic – and resilient.
- I don't intend to present a potted history of these reforms, but rather some general lessons we have taken about the process.
- First, the reform process is by nature a long term process, and benefits take time to materialise. Moreover, it is complex, with many interrelationships across other sectors and other aspects of policy – not all of which are clear or predictable at the start of the process.
  - It is certainly not a linear process and some transition costs, as players adapt to the new environment, are inevitable.
- This poses significant challenges in terms of maintaining political and community support, and the related issue of sequencing
  - The latter is often discussed as if it is essentially a technical issue, but I would argue it is as much if not more about managing the politics of reform.

- In the Australian context, the reform process has been assisted by regular independent, broad ranging inquiries which have helped manage the political debate, and build consensus.
- The existence of a broadly agreed policy framework and direction has been crucial to allowing governments and policy advisers to manage short term setbacks and uncertainties.
  - Sequencing is an art, not a science, and there has to be scope for policy opportunism, in which one attempts to build on the policy interrelationships referred to earlier to establish a self-reinforcing momentum for reform
- In Australia, financial sector reforms have provided the impetus to liberalisation of product and labour markets, and reforms to enhance the efficiency of the non-traded goods sector, which together have allowed the adoption of a more medium term approach to macroeconomic policy. At the same time, the development of the financial sector has benefited greatly from retirement income reforms.
- Successful financial sector reform also requires extensive consultation with, and input and support from, the financial services industry itself. The increasing complexity of financial sector activities makes this essential if one is to minimise unintended consequences.
- And financial sector reform is a continuing process – there isn't a stable end point.
- In Australia, we have recently been revisiting a number of issues, such as:
  - The regulatory compliance burden
  - The need to get the balance right between stability and investor security, and the promotion of competition, innovation, and efficiency
  - The adequacy of disclosure arrangements in the non-prudentially regulated parts of the sector
  - And related to that, and the challenge of ever increasing complexity, the scope to enhance financial sector literacy and understanding of risk among the general public
- Finally, let me briefly say something about the potential for enhanced co-operation at the regional level to strengthen the region's financial markets.
- The blossoming and strengthening of regional cooperation efforts has, in my opinion, been one of the most positive developments to emerge from the 1997-98 crisis.
- To date, the focus has been on advancing regional financial cooperation and integration through the ASEAN+3 Chiang Mai Initiative network of currency swap agreements, and efforts to develop local and regional bond markets, including the Asian Bond Fund (to which Australia has contributed).
- Going forward, the challenge will be to ensure that the region's key groupings – including APEC, ASEAN+3 and the East Asia Summit – evolve in such a way that they are seen as distinctive, yet mutually reinforcing, elements of the wider regional architecture.
- Let me focus a little on APEC, given Australia's chairing of the 2007 process.
- APEC's breadth of membership, consensual style, and capacity to mobilise resources for technical assistance ensure that it is ideally placed to support efforts to further develop the

region's financial markets. APEC allows economies to talk privately with each other about objectives and principles, how to implement them in practical ways, and how to support this process by strengthening domestic institutions and providing technical support.

- One modest, but still significant concrete example of this is the endorsement by APEC Finance Ministers, in August of this year, of an Australian proposal, co-sponsored by China, Indonesia and the ADB, to develop a web-based catalogue of financial sector reform policy experience and choices, to further facilitate constructive exchange between APEC officials on the practical challenges involved.
- Another, more important, example, is the agreement within APEC for a greater focus on behind border structural reform issues, with a special meeting of relevant Ministers to be held next year on this in Australia.
- As an Australian, I should also note that we see the East Asia Summit, although still at a formative stage, as offering a further avenue for bringing additional perspectives to bear on the challenges faced by the region's financial markets, .
- So, the tools for regional co-operation are broadly in place; the challenge is to make the best use of the full range of these forums.
  - This includes ensuring that a regional perspective can be brought to bear on whatever lessons emerge from the current market turbulence, for both governments and market participants.
- Thank you. I look forward to participating in the ensuing discussion.