Keynote address to Asian Financial Forum

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[as prepared for delivery]

Thank you for that kind introduction. It is a pleasure to be here today in such distinguished company, and at this important occasion.

Introduction

I would like to focus my remarks today through the lens of the financial system, and examine the changes that have taken place in Hong Kong SAR and in the global financial landscape in the past decade. I would also like to look at the present developments in global markets, and ultimately draw some lessons from the Hong Kong SAR experience over the past decade to discuss the challenges going forward.

A decade ago, leaders of the international financial community were meeting here in Hong Kong[1], just as the Asian crisis was beginning to unfold throughout the region. Unbeknownst to many at the time, a potent mix of rapid capital inflows, fragile banking systems, a leveraged corporate sector, and unhedged foreign borrowing provided the ingredients for a severe crisis across the region. Although Hong Kong

[1] IMF/World Bank annual meetings held September 17-25, 1997, Hong Kong convention and exhibition center.

SAR was better positioned at the onset of the crisis, even the currency board came under pressure in 1998, and the subsequent decade saw the economy face unprecedented challenges from a variety of shocks.

Hong Kong SAR Transformation

In the decade since then, we have seen the remarkable recovery of the region, the return of capital flows, dramatic improvements in balance sheet structures and underlying fundamentals, and the undisputed rise of Asia and mainland China in particular as a key global player. At the same time, the Hong Kong SAR financial landscape has evolved dramatically. The ongoing transformation of the economy from a manufacturing-driven to a service-driven system created huge shifts in employment and finance. The Hong Kong SAR banking system weathered a reduction in banking activity from its peak in 1997, at the same time as barriers to foreign bank activities were eased. Equity markets grew in importance, particularly for IPOs, helping to integrate Hong Kong SAR more closely into the Chinese economy as an important conduit for finance, and cementing Hong Kong's role as a key regional and global financial center.

All of these dramatic structural changes were not without costs, and at times they were substantial, but they do highlight the importance of a stable supervisory and regulatory framework to ensure the financial system can cope with the stresses and strains that are inevitably produced with such change. At the same time, it is also important for regulators to be nimble themselves in adapting to the emerging risks and challenges that are thrown up by constantly evolving markets and products. [Hong Kong SAR has managed to achieve this delicate balance, and this has served the region well in terms of stability, growth, and future prospects]

Global Transformation

At the same time as the dramatic changes going on in the region, the global financial system has undergone a similarly spectacular transformation. Over the last decade, cross-border financial flows have increased more rapidly than either global output or trade, and have tripled to around 14 per cent of world GDP (or $6.4 trillion). This trend is being driven by three dramatic changes: the rapid growth of assets under management of institutional investors; the changes in their asset allocation behavior as ‘home bias’ declines; and the broadening of the global investor base. The growth in assets under management of institutional investors (pension funds, insurance companies, and mutual funds), has been remarkable, increasing from $21 trillion to $53 trillion between 1995 and 2005. At the same time, emerging market central banks and sovereign wealth funds have become key global players in cross-border asset allocation. Central banks, especially in Asia, have accumulated more than $5 trillion, and SWFs, are estimated to hold more than $1.5 trillion. Assets under management of hedge funds and private equity funds have also seen rapid growth. According to market estimates, assets under management of the hedge fund industry, though small compared with other institutional investors, grew from $30 billion in 1990 to more than $1.4 trillion at the end of 2005.

This surge in cross-border flows and the shifting importance of different institutions over the past decade highlights the need to take a global view of financial market evolution, and recognize the challenges and opportunities they pose for policy makers. With the growth in large cross-border financial institutions, and the growing correlation among global asset markets, it is no longer possible to take a local view of risk or risk management. Just as flexible policy making is necessary to provide the suitable environment for domestic economies to adapt, this is also true in a global sense.

Recent research that we have conducted as part of our Global Financial Stability Report has shown again that a well-functioning domestic financial market encourages capital inflows and reduces their volatility over the medium-term. The results show that for a large sample of developed and emerging market economies from 1977 to 2006, greater equity market depth and liquidity, and financial openness, positively influence the level of capital inflows. Other estimates show that more financial market openness reduces volatility of inflows over the medium-term. In addition, a number of indicators of institutional quality, such as rule of law, and high regulatory standards are associated with lower volatility of inflows. These results support the view that coping with global flows requires a flexible policy framework aimed at encouraging financial market development over the medium-term, grounded in policies such as a well-regulated financial system, better transparency, broader institutional quality, and improved risk management for financial institutions. Putting these elements in place are the most effective policies to cushion the financial system from the potentially destabilizing effects of volatile capital flows.

Challenges of recent market turbulence

Next I would like to turn to the ongoing challenges presented by the recent turmoil in financial markets. Here we see that global financial stability is enduring an important test. Markets are recognizing how credit discipline has deteriorated in recent years, and this has triggered a repricing of credit risk, and a reappraisal of risks in other financial markets. We have seen how disturbances in one part of the financial system can be transmitted, sometimes through opaque and intertwined channels, to all other parts of the financial system. The role that structured products play in concentrating credit and market risks has been dramatically illuminated. The importance of liquidity—taken for granted in good times, but causing consternation when it suddenly evaporates—has again been made clear. The pivotal role that ratings agencies play in forming risk perceptions in the investment process has also been highlighted. In a sense the recent turmoil is a test of the new financial architecture of credit-risk transfer instruments, and a move away from traditional bank-based finance to a model of originate and distribute.

What is clear from this recent episode is that the process of adjustment to the recent turmoil will take time, and we will have to examine how the system has functioned to derive lessons. The task for policymakers and market participants now is to take those lessons and use them to help make the global financial system even stronger. This does not require, as some have suggested, an entirely new regulatory paradigm, but we must be ready to re-examine some elements of the framework we have, and to enhance it where necessary. We see five key areas for consideration.

- First is the important role of uncertainty and lack of information. Accurate and timely information about underlying risks are critical components in the market's ability to properly price risk. Greater transparency is needed on links between systemically important financial institutions and some of their off-balance sheet vehicles. Only by disclosing fully their interrelationships with asset managers, conduits, and special purpose entities will investor be able to assess their true credit worthiness.

- Second, while securitization, and financial innovation more generally, have made markets more efficient, enhanced risk distribution, and facilitated the ongoing globalization of markets, there is a need to understand how the incentive structure may have diluted the incentives for originating lenders to monitor risk. Generally, the relation between the checks and balances throughout the supply chain of structured products may require some rethinking.

- Third, ratings and rating agencies will continue to be a fundamental and necessary player in the functioning of financial markets. As we have said in our Global Financial Stability Reports, differentiated ratings scales for structured products could alert investors to the scope for more rapid ratings deterioration in such instruments, compared to, for instance, traditional corporate or sovereign bonds. Similarly, investors should make sure their portfolio allocation decisions are not simplistically reliant on letter ratings, and that such ratings should not be used as a substitute for appropriate due diligence.

- Fourth, the valuation of complex products in illiquid markets requires more consideration. Given the interactions between market liquidity and funding liquidity, more work on best practices in liquidity management is necessary. The provision of liquidity insurance should take into account the business model of the institutions involved, and the potential need for more capital.

- And finally in this complex world, the relevant perimeter of risk consolidation for banks has proven to be larger than the usual accounting or legal perimeters. There are two notable examples: (a) reputational risk may force banks to internalize losses of legally independent entities; and (b) new instruments or

> structures may mask off-balance sheet or contingent liabilities. The result is that risks that appear to have been distributed may yet return in various forms to the banks that distributed them. The relevant perimeter is not only an issue for supervisors, but also for the financial institutions themselves—their risk managements systems, their audit processes and internal oversight and governance structures.

Policymakers now face a delicate balancing act to strengthen prudential frameworks to encourage investors to maintain high standards in good times as well as bad, while preserving the benefits of financial innovation.

But the turmoil is also a broader test of a decade of reforms outside the major developed markets, and how the improvements in their balance sheets and the evolution of a new dedicated investor class of EM assets has changed the dynamics of the global financial system. So far, emerging markets have weathered the turbulence relatively well. This reflects their favorable fundamentals, strong liquidity positions and robust growth. Nevertheless, there remains the risk that turmoil in mature markets may have more sizeable spillovers to emerging market countries. Some of the credit deterioration seen in mature markets is expected to occur in some emerging market countries going forward, particularly for those that have been experiencing rapid credit growth. This concern is heightened in countries where credit extension has been primarily foreign currency denominated or where other vulnerabilities are also present, such as a large current account or fiscal deficit. But the real test will be whether EM can continue to prosper through a period of greater uncertainty and higher credit spreads, without a retreat of foreign capital.

Policymakers here in Asia face similar daunting challenges in responding to the changed financial environment. The risks that we have seen in other markets are all present here to some degree. First, you also face the need for greater transparency, as the growth in the financial sector away from the core of regulated institutions presents challenges for policy makers, as they typically have less timely and reliable information on non-regulated entities, and have fewer policy levers to apply in times of difficulty. This also increases the importance of voluntary standards of disclosure by market participants, as well as the sharing of information across regulators and across borders. Second, the gradual shift of financial activity away from traditional banking business lines to a more originate and distribute model and a greater role of equity finance presents challenges for supervisors and investors alike, as they struggle to promote better assessment of risks in a more complex environment. And finally, as the financial systems of different countries continue to become more closely intertwined and the complexity of financial products increases, you will face the same pressures, risks, and challenges at the heart of the present turmoil. Questions of liquidity premia, incentives structures, and the perimeter or risk consolidation will grow in importance to investors and supervisors as the complexity of financial transactions and institutions grows. These challenges will not get easier with time, and there will inevitably be setbacks like the present turmoil in global markets.

In closing, I would like to leave you with the following thoughts. Hong Kong SAR and mainland China have chosen to become more closely integrated with the world economy and the global financial system over the past decade, to the great benefit of their citizens and the rest of the world. An inevitable part of that integration is greater financial complexity, and with that comes the possibility of greater volatility at times. However, as I mentioned earlier, well functioning financial markets and financial openness helps to reduce volatility over the medium term. The challenge that we all face then is how to manage the process of adjusting to this complexity, to ensure our citizens the maximum benefits from being part of the global economy. The important lesson that I take from the last decade in Hong Kong SAR is the importance of strong, stable policymaking institutions, constantly striving to improve regulatory and supervisory standards, supported by prudent macroeconomic policies. The great strides shown by Hong Kong SAR and mainland China and by many other countries in Asia over the past decade in this direction stand as good examples of how to benefit from the transformation of the global financial system by adhering to these sound principles.

Thank you.