

**Keynote Remarks by Joseph Yam**  
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**Introduction**

Ladies and gentlemen, I am very glad to have the opportunity to speak at this Global Bond Summit, all the more so because it is being held here in Hong Kong and because development of a deep and liquid bond market in Asia is a subject that is very close to my heart.

It has been suggested that I should talk specifically about the Asian Bond Fund (ABF) initiative. I am happy to do so not only because ABF is an important initiative for promoting the development of bond markets in the region but also because of the active involvement of the HKMA in the past three to four years in the project, including chairing the EMEAP Working Group that gave birth to it. But I cannot, of course, speak for the eleven central banks and monetary authorities comprising the EMEAP group, but only for the HKMA, and so my comments today are those of the HKMA.

**Asian Finance**

Let me begin at the more macro level and draw your attention to one aspect of Asian finance that has always struck me as odd, and this is how financial integration in Asia is lagging behind economic integration. With over half of total trade in Asia being intra-regional trade, and with this proportion still on an increasing trend, economies in the region are becoming increasingly interdependent among themselves, arguably more so than each of them depends on the developed economies in Europe and America. By comparison, the degree of financial integration in Asia is disproportionately low. For example, all of the Asian economies have probably lent more individually to the United States than they have collectively to other Asian economies.

Whether we like it or not, we now find ourselves in the unenviable position of holding a substantial part of our savings in the financial liabilities of an economy that does not save, fearing that a diversification of a small part of such holdings might lead to a sharp fall in the value of the rest, thus shooting ourselves in the foot. We also find ourselves somewhat stuck with recycling a large part of our savings through the developed markets back into the region in a much more volatile form, occasionally creating havoc in our monetary and financial systems.

We find ourselves — we are told - contributing to the global imbalance by saving too much and spending too little, although those that tell us pay little attention to the fact that we do have typhoons and heavy rains, earthquakes and tsunamis, and we need to ensure that we are able to help ourselves as much as possible in case of need. They also pay little attention to the traumatic experience of the Asian financial crisis of 1997-98 and the natural inclination to build up

ammunition, in the form of foreign currency reserves, ever since. After all, most of us are small, in terms of our economies and our political influence, and the reality of this world is that, when you are small, you are more likely to be tossed around. So we need to be more cautious in our finances.

We find ourselves being held, at least partly, responsible for the dilemma currently surrounding the global imbalance, which has been interestingly described as a "stable disequilibrium". The description begs the questions as to how long the disequilibrium will remain stable and whether the eventual adjustment path to equilibrium is likely to be an unstable one. The answers to these questions remain elusive.

This obviously is not a very comfortable position that we find ourselves in. One solution to this structural problem in Asian finance, at least to us in the HKMA, is greater Asian financial integration to promote the stability, integrity, diversity and efficiency of financial intermediation across jurisdictions in Asia. At the micro level, an obvious, non-controversial initiative that Asian jurisdictions support, although not necessarily for the same macro reasons that I have described, is the development of the domestic and the Asian bond markets, hence the EMEAP ABF initiative.

### **Asian Bond Fund**

As I mentioned earlier, the HKMA has the honour of chairing the EMEAP Working Group to lead the initiative. This began in 2002 and in June of the following year, EMEAP launched ABF1. ABF1 invests in a basket of US dollar-denominated bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP markets — China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand. It was a small but significant step forward. Think about it for a moment: eleven very different economies of different sizes, with different economic structures and stages of economic and social development, co-operating for the first time to set up a bond fund and lay the foundation for promoting the development of regional and domestic bond markets in the Asian region.

The next, bigger step was ABF2, which extends the concept to bonds denominated in Asian currencies. There are two parts to this: the Pan-Asia Bond Index Fund (PAIF) and eight Single-Market Funds. The PAIF is a single bond fund investing in sovereign and quasi-sovereign local currency-denominated bonds issued in the eight EMEAP markets, while the Single-Market Funds invest in similar bonds issued in the individual markets. So far, the PAIF and three Single-Market Funds in Hong Kong, Malaysia and Singapore have been listed. The remaining five Single-Market Funds will also be offered to the public within the next couple of months. I am glad to see that the ABF Hong Kong Fund has been well received by the market, growing by over 40% since its listing in June this year.

The ABF2 project has been a good example of co-operation between the public and private sectors.

While this is an official initiative with seed money of US\$2 billion provided by the EMEAP central banks, we relied on the private sector for product design, implementation and marketing. The nine fund managers and the global custodian for the nine funds were selected based on a very competitive process. After all, the private sector is much better at making these products market-oriented than central bankers.

The ABF initiative has also been successful in a wider sense in a number of ways. First, it has helped to promote product innovation. ABF2 Funds by themselves represent a new class of bond products, which has helped to raise the awareness of Asian bonds among investors. Some ABF2 Funds take the form of a bond Exchange-traded Fund (ETF), which is the first of its kind in Asia. They are a convenient and cost effective way for regional and international investors to gain exposure to Asian bonds. With their low costs and low entry thresholds, the funds also facilitate retail participation in bond markets. ABF2 has also led to similar products and derivatives coming into the market. We notice that some banks have come up with their own Asian bond funds, a welcome development, while an investment bank has issued a structured note using PAIF units as the underlying asset.

Second, ABF2 has led to improvements in financial market infrastructure. The iBoxx ABF Indices, the benchmark indices for the ABF2 Funds, are transparent and credible and compiled by an independent index provider. They can be easily replicated and customised by the private sector for other fixed-income products and derivatives and represent an important piece of market infrastructure for Asia. Moreover, since bond ETFs are a new product in Asia, in a number of cases, the linkage between the clearing and settlement systems for debt securities and that for equities have to be improved in order to allow the listing and trading of a bond ETF on the stock exchange.

Third, the ABF initiative has been a catalyst for regulatory and tax reforms in EMEAP markets, helping to remove market impediments and facilitate financial integration in the region. For example, the PAIF is the first foreign institutional investor to be granted access to China's interbank bond market. Securities regulators in Malaysia and Thailand have recently issued new rules to facilitate listing of ABF2 funds as bond ETFs. Malaysia and Thailand have exempted non-resident investors from withholding-tax, and Malaysia has liberalised its foreign exchange administration rules. Both Malaysia and Thailand opened their domestic bond market to bonds issued by multilateral financial institutions such as the World Bank.

Fourth, the ABF initiative has helped to standardise and harmonise documentation for this type of exercise. The trust deed and prospectus of the PAIF, which comply with laws and regulations of Hong Kong and Singapore and are in line with international standards, served as a model for the drafting of fund documents for the ABF2 Single-Market Funds. This has helped to promote the adoption of international best practices among EMEAP economies.

## **ABF and Financial Stability**

Let me turn to the other question that I have been asked specifically to address, and this is how the ABF initiative can contribute to financial stability in the region. I must confess that, even though the central banks in the region have been enthusiastic in the development of the project, the benefits of ABF to financial stability in the region have not been clearly articulated in our deliberations. I can assure you, however, that this is not a reflection of any lack of brains on the part of Asian central bankers or because the objectives have not been clearly defined, although there may be a lack of a clear road map. But it should be all right, as Deng Xiaoping pointed out, to cross the river by feeling the stones. The lack of a clear linkage between ABF or indeed debt market development generally and financial stability is more a reflection of the difficulty of defining what financial stability is.

Indeed, the question has been receiving increasing attention in the international financial community, and attempts are being made on both the academic front and among those with policy responsibility to model financial stability and integrate it with the more traditional macroeconomic analysis, in both the domestic and international dimensions. I await with keen interest the emergence of an authoritative analytical framework of general application. Meanwhile, I share the views of some that financial stability can be negatively defined as the lack of financial instability, given that it is easier to define what the latter is. In my opinion, when the financial system fails to function properly, in terms of mobilising savings to finance economic activities — the all-important process of financial intermediation that promotes economic growth and development — then there is financial instability. When, as a result of a shock to the financial system, money is suddenly not available even for the creditworthy fund raisers no matter how high a price they are prepared to pay, then financial stability is not achieved. Alternatively, when, because of a breakdown of confidence for one reason or another, those with surplus money are simply not willing to trust the financial system with it, by placing it with banks or investing in financial instruments, then financial stability is not achieved.

With this somewhat inadequate analytical framework in mind, then it is clear, at least to me, that ABF, by increasing the diversity of financial intermediation channels, reduces the probability of disruption in the all-important process of financial intermediation and the occurrence of financial instability, thus contributing to financial stability.

There is another dimension of financial stability that we have considered in our deliberations on ABF. Although the empirical evidence is probably difficult to establish, given the increasing degree of intra-regional dependence in Asia, we feel that regional savings are probably less volatile than savings from the developed markets. This is partly also because the management of savings from the developed economies is more sophisticated than that of regional savings, with a much

greater involvement of financial institutions, including hedge funds, which are a lot more nimble and probably also have a different perception of risks in the region. By contrast, those mobilising regional savings within the region probably have a better understanding of regional issues, although we should not expect them always to take account of the wider public interest in their purely commercial activity of fund management. Thus if ABF acts as a catalyst for a greater proportion of regional savings being recycled within the region, instead of through the developed markets of Europe and America, there is likely to be some benefit to financial stability.

### **What Next in ABF**

Let me turn to the question of "what next" in the ABF initiative. I am acutely aware of the fact that the HKMA is only one of eleven central banks and monetary authorities in the EMEAP group and that the ABF project is an EMEAP project, and not an HKMA project. As I said earlier, I cannot speak for EMEAP, although ABF1 and ABF2 were developed while the HKMA had the honour of chairing the relevant Working Group. Indeed, we are scheduled to hand over chairmanship in May next year, having exceptionally provided the chair for two consecutive two-year terms. But allow me to tell you, nevertheless, what we in the HKMA think could be possible directions to be explored.

There are two such directions, which hopefully could lead to an ABF3. First is to enlarge the scope of credit acceptable to the central banks as investors, but address the problem of inadequate credit quality through credit enhancement or guarantee arrangements. Second is the securitisation of bank assets. Both are familiar concepts to the financial markets, and so there is no need for me to elaborate, other than to say perhaps that we favour simple products that can be readily understood not just by simple-minded central bankers but also by the not-so-sophisticated investors in the region. We support the EMEAP and other regional fora to further look into these ideas. And we look to the private sector to participate fully in this continuing effort.

Let me close by going back to financial stability and say that the ABF initiative, whether it gets to ABF3 or ABF4 or ABFN, is not the full answer to financial stability in the region. Asia is particularly vulnerable to financial instability because of, principally, the size of the individual, fragmented markets, relative to international capital, and the openness of those markets, assuming that prudent macroeconomic policies are a pre-requisite that is always observed. To reduce vulnerability from those sources, without stepping back from maintaining open markets, we need greater financial integration or co-operation, and perhaps one day monetary integration. But these subjects should best be left for another day.