Opening Remarks by Mr GR Stevens, Deputy Governor, to the 18th Australasian Finance and Banking Conference 2005, Sydney, 14 December 2005.

It is a pleasure to be here to open the 18th Australasian Finance and Banking Conference.

Our national and international financial markets play an increasingly prominent role in day-to-day life. They are certainly in the news. Not a single television or radio news bulletin passes without us being informed of the latest daily, or even intra-daily, movement in the US stock market, the exchange rate, the price of gold and – probably of more interest to the average person – the price of crude oil.

I suspect that, to no small extent, this almost obsessive focus on short-term price movements reflects the need for a high-capacity media to have a large amount of apparent 'news' to convey, even when the quantity of genuine information is small. The high-frequency nature of financial market trading – a new piece of 'news' every minute – is a natural source of grist for this particular mill. How useful this actually is, on the other hand, one could debate.

Likewise, the short-term reporting schedule of corporate and fund management results is perhaps understandable, viewed from the perspective of accountability in an era in which trust in management has been weakened. But, at the same time, it probably exacerbates the natural human tendency toward myopia and impulsive decision-making by investors, while the attendant pressure on managers to deliver steadily improving results period by period hardly seems conducive to far-sighted decisions. It remains to be seen, moreover, what will be the effect on behaviour of changes to accounting standards which will almost certainly increase the apparent short-term volatility of corporate results. Some have argued, I think persuasively, that an undue focus by investors and managers on the short term is a significant impediment to long-run performance. This seems an issue worthy of further study. Hopefully, you might spare some time for that at this conference.

In any event, there is no doubt that the functioning of our financial systems is very important. Once upon a time, when asked what was the role of a financial system, we might have answered: to match the resources of savers and the needs of entrepreneurial types, so as to enable the deployment of capital in some prospectively profitable venture. That (rather 19th-Century-sounding) definition, with an emphasis on intermediation, is still correct as far as it goes. But these days, with an increasing proportion of society's capital – even our infrastructure – held in marketable form, the role of markets in pricing assets is key. We would add, as well, that the role of a financial system is to price risk, in ever more finely defined bundles, and to allow people to adjust their portfolios so as to be exposed to just those risks, and opportunities, that they desire – no more and no less.

The system's efforts to provide just that set of possibilities has led to a plethora of sophisticated and increasingly complex products. This development, in turn, has raised questions by various observers and regulators as to whether those who have ended up holding certain risks are fully aware of them. Questions have also been asked of late about the back-office infrastructure supporting the most complex transactions, and there is a degree of concentration in some of these markets which could conceivably be problematic under less benign market conditions.

Nonetheless, these functions beyond pure intermediation seem only likely to grow further in importance for various reasons, not least among them demographic trends. As people confront longevity risk, in addition to the usual battery of market risks, the search will be on for new instruments and practices which enable this risk to be priced and managed. While it is highly doubtful, in my view, that ageing can be addressed simply by financial engineering, the financial system will have a role to play. Its effectiveness and efficiency in that role will be a focus of discussion in years to come. It's appropriate, therefore, that some parts of the conference program will be devoted to topics in the retirement income area.

It is also fitting that the conference has adopted the title 'Financial Challenges and Opportunities in the Asia Pacific Region for the 21st Century'. The Asia-Pacific has been, and remains, a source of economic dynamism – that's the 'opportunity' part. But it has also been a scene of considerable financial turmoil over the past decade – that is the 'challenge' part.

You have had some thoughtful presentations this morning on some of the issues. I could not do justice to all of them in brief remarks. Allow me to touch briefly on just a couple of themes.

The first is the potential, and need, for financial development in Asia. It has been apparent for some time that east Asia's weight in global production of goods and services is increasing (Japan aside). Non-Japan east Asia, including China, has seen its share of global GDP almost double, to about 20 per cent, since 1990. It is likely to rise further in the period ahead. The extent of merchandise trade within the region has also grown rapidly, as trade barriers have declined and cross-border component sourcing has increased. So Asia is, these days, a powerful force in international trade.

Yet, according to many east Asian people themselves, the development of Asia's financial system has not kept pace. It is not so much the size of the banking systems which is in mind here – in a number of cases, these are actually quite large (though there are some important exceptions like Indonesia, or the Philippines). Rather, it is the depth, resilience to shocks and capacity to intermediate the region's savings within the region that is at issue.

With the onset of the financial crisis of 1997–98, it was apparent that Asia was not resilient to disturbances in international capital markets. Foreign capital had flowed into east Asia – something which made sense then, and still makes sense now. The exchange rate risk associated with these flows, however, was being borne mostly in the recipient countries: they had borrowed foreign currency unhedged. The result of these exposures was that, when exchange rates moved, the pain was concentrated in banks and/or their customers in Asia, something which exacerbated the crisis and put policy-makers in an impossible position. Because of heavy reliance on bank funding, with somewhat under-developed general capital markets, this was very damaging for a number of regional economies.

Post crisis, still keen on a fair degree of exchange rate stability, but unsure of the extent of likely support from the international community in the event of another crisis, the countries of east Asia have opted for greater self insurance against volatility of international capital flows. This takes the form of vastly increased holdings of official reserve assets, mainly the US dollar.

While this response has been understandable, some even in Asia have questioned whether it makes sense for Asia to operate, in effect, as an extension of the US dollar zone.

Joseph Yam, Chief Executive of the Hong Kong Monetary Authority, laments the situation in the following terms:

> 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.[1]

The challenge for Asia then, according to its own financial leaders, is to develop a financial system which can allocate local savings to local needs more directly, can be resilient to the risks associated with international capital flows, and be somewhat less dependent on banks as a funding channel.

This is no small task. Thus far, apart from managing the fall-out from the crisis, efforts have been made to strengthen banking systems. A good deal of work has also occurred to improve capital markets, particularly bond markets.

One of the key breakthroughs will be when Asian governments and corporates can borrow as needed in open markets, in their own currency and at an acceptable price, leaving any currency risk to others willing to bear it – like foreign investors. Australian borrowers have been in this happy position for a long time now, like their counterparts in other advanced economies. For emerging-market countries to enjoy the same opportunity would be a major improvement on the past.

For this to occur, there needs to be a confluence of high-quality issuers, informed investors, and well-functioning markets to allow hedging and swaps. As Asian authorities seek to facilitate the development of these markets by removing impediments, and the occasional modest official transaction, opportunities will presumably exist for capable market players in Australasia to play a role.

Opportunities might also lie, perhaps over a longer horizon, in the area of household finance, since the number of middle-income Asian households is rising quickly, and their income growth is rapid. It could be anticipated that their demand for more sophisticated asset and liability products will correspondingly grow. One would think that Australasian institutions would be well placed, given the skills acquired in their home markets, to take part in any such development.

A second, not unrelated, theme is the so-called 'global imbalances' issue. There is no time to rehearse all the arguments here, but one simple point can be made. As the size of capital flows from Asia to the US increased over the past decade or so, the price – the interest rate – *declined*. Hence, it would appear that developments on the supply side of this market were very important

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1 *Remarks made at the recent Global Bond Summit, Hong Kong, 14–16 November. Available at <http://www.info.gov.hk/hkma/eng/speeches/speechs/joseph/20051115e1.htm>.*

in driving the phenomenon. That is a reminder that if the capital is to flow more slowly to the US, adjustments to Asian behaviour will be part of the process.

The increased net supply of saving from Asia reflected a sharp decline in corporate investment in the Asian region (outside of China) after the crisis. At some point, Asian corporate investment will presumably recover. One would also imagine that, in some cases, there is a need for upgrades to public infrastructure, and a case for higher-quality private housing. Hence, in due course, the net supply of Asian saving to international markets, other things equal, will decline. Just when that will be, of course, and what other changes might accompany such developments, no-one can say. But no discussion of the challenges in the Asia-Pacific region would be complete without some coverage of such issues.

Let me conclude by saying how fitting it is that the conference takes place in Sydney, one of the Asia-Pacific's major financial centres. As the first largish market to open in the world trading day and as the financial centre of a medium-sized, developed economy, Sydney plays a prominent role in the region's financial trading, even though some other markets are somewhat larger. It is the leading market for the world's sixth most actively traded currency. Australia's share of global foreign currency trading, at about 3½ per cent, is higher than in a number of comparably sized economies, and is about three times Australia's weight in world GDP. Markets here are sophisticated and liquid, and the participants innovative. Sydney, and Australia more generally, has much to offer the region in financial services expertise. That said, participants here would be only too aware that financial market operations are highly competitive and the local players need to remain on their toes. So it is good to see some local market participants thinking about how to contribute to the development of vibrant markets in the region.

These and other interesting issues will no doubt be covered in the conference, if they have not already been. I wish you well in your deliberations.