HONG KONG'S CURRENCY BOARD TODAY: THE UNEXPECTED CHALLENGE OF DEFLATION[1]

The emergency of price deflation in Hong Kong, apart from being a cyclical phenomenon, may also be the product of some fundamental institutional and structural factors. This article examines the underlying forces behind recent deflation in Hong Kong. It concludes that Hong Kong's Currency Board system has been only one of a number of contributory factors.

The Conquest of Inflation

Most of today's adult generation around the globe have lived their lives in the shadow of at least mild, if not quite rapid inflation. And today's central bankers have for the majority of their careers been struggling to cope with inflation.

It is therefore hardly surprising that back in 1983, when the Hong Kong authorities pegged the Hong Kong dollar to the United States dollar, price deflation was not a matter for consideration. The US inflation rate in the early 1980s was averaging some 4% pa and, in the absence of any special forecasting capability in this field, it might have been reckoned to remain near that figure. In addition, structural and developmental factors would have been expected to make Hong Kong's inflation rate somewhat faster than that of the USA – as indeed it was for the ensuing fourteen years. Neither a significantly lower rate of US inflation nor a situation where Hong Kong's rate was significantly below the US rate would have been considered at all likely.

Yet Hong Kong now finds itself with a consumer price level that is 12-13% below the peak of four years ago, and with a GDP deflator some 15% below its peak and 22% lower relative to that of the USA than it was four years ago. What is the explanation, and can one live with this?

There is general consensus, supported by both recent IMF analysis and research conducted within the HKMA, that Hong Kong's deflation is predominantly cyclical, though by no means exclusively so. Before specifically considering Hong Kong, however, it is useful to examine the global slowdown in inflation.

Over the past four years the rate of consumer price inflation has averaged 2.5% in the USA, only 1.7% in Euroland, minus 0.3% in Japan, and minus 0.3% in Mainland China. In six other economies of east and south-east Asia taken together, the inflation rate fell to 2.7% on average in these four years as against 4.4% in the preceding four.[2] This widespread abatement of inflation, and in some cases the emergence of deflation, is almost certainly not just a cyclical phenomenon. Some more fundamental institutional and structural factors have probably been contributing.

Underlying Forces

(a) Successful central banks

First of these is the commitment of monetary authorities around the world to combatting inflation and their evident success in doing so (or even over-achievement in some instances).

(b) The supply side – history repeats itself

Second is the argument that the world is merely reverting to its more natural historical state of a disinflationary tendency, following the interruption of the second world war and ensuing decades.[3] The current trend is, on this view, being driven not only by the productivity gains made possible by the IT revolution but also by the evolution of China and some other emerging economies as a huge competitive and price-reducing force in world markets,

1 Adapted from remarks delivered by Tony Latter, Deputy Chief Executive, in the session, "Fixed versus float – what have we learned from the 1990s?", at the conference on "Alternative exchange rate regimes in the globalised world", organised by Eesti Pank to mark ten years of the currency board in Estonia, in Tallinn on 11 June 2002.

2 Average for Malaysia, Philippines, Singapore, South Korea, Taiwan and Thailand, weighted by nominal GDP. Indonesia is excluded because of its considerable institutional and political instability in the period – it suffered particularly intense inflation in 1998-99.

3 The author is grateful to Eisuke Sakakibara for a lucid exposition of this point in an address in May 2002 to the Hong Kong Foreign Exchange and Money Market Practices Committee. Also, the 69th Annual Report of the Bank for International Settlements (pages 77-81) provides an interesting snapshot of the topic, as seen three years ago.

in a manner reminiscent of the productivity surge and market opening which produced falling price levels in other parts of the globe in the closing decades of the nineteenth century.

As illustrated in Charts 1 and 2, in the thirty years 1865-95 consumer prices are estimated to have fallen by 48% in the United States and 27% in the United Kingdom – average compound annual

Chart 1

CPI and Real GNP of US (1850-1940)

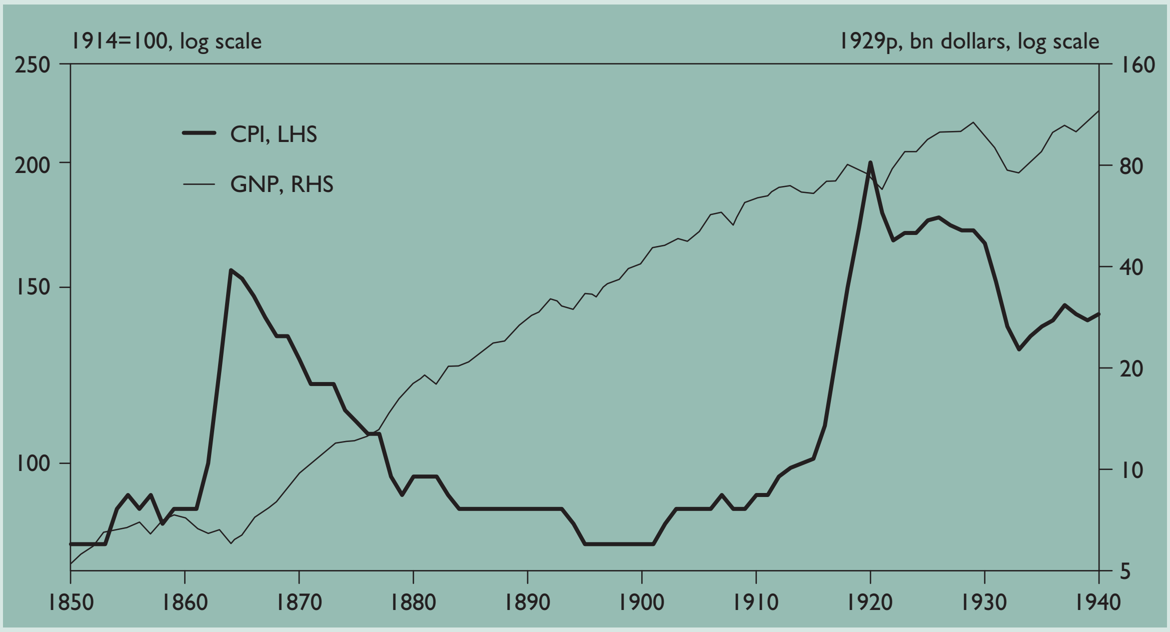
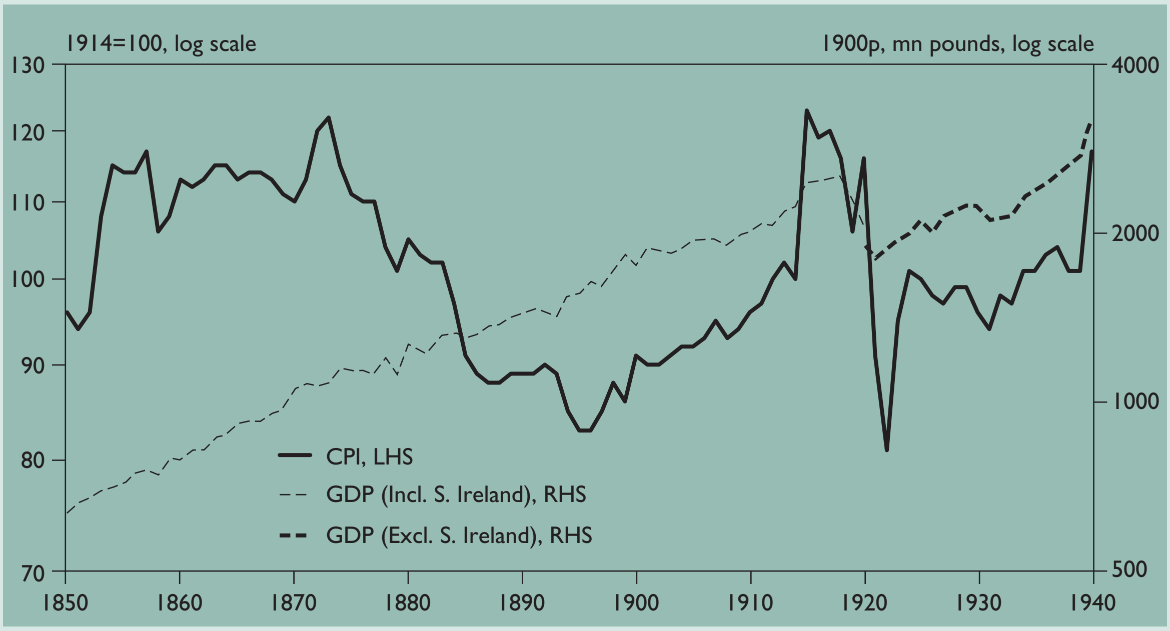


Chart 2

CPI and Real GNP of UK (1850-1940)



Source: International historical statistics: Europe 1750-1993 / B.R. Mitchell, London: Macmillan Reference: New York, N.Y. : Stockton Press, 1998 rates of decline of about 2% and 1% respectively.[4] This is generally regarded as having been a supply-side-driven phenomenon arising from rapid productivity growth alongside abundant labour supply, aided by the opening-up of new markets globally. Despite price deflation, the world economy prospered: real GDP growth averaged 5-6% pa (admittedly boosted by immigration) in the USA and $1^3/_4$% in the UK in that period. Subsequently, modest inflation took over, but did not reach a serious scale until the first world war.[5]

The inter-war years were rather different from the late nineteenth century episode. There was a mixture of deflation and inflation – but with the former arguably being more the result of monetary policy mistakes, such as those associated with the Great Depression, than of supply-side forces such as were so plainly evident half a century earlier. Inflation did not really become re-established on a significant scale until the second world war, after which it persisted for most of the remainder of the twentieth century.

Most recently, the potential problems posed by deflation, which may be particularly serious in a financially developed world where balance sheet effects are important, have become apparent, most notably perhaps in Japan.

All in all, there is perhaps a mixed message from these historical examples. It may be possible to live comfortably with a modest pace of deflation, especially if it reflects benign supply-side influences. Nevertheless, monetary policy might usefully be engaged to avert it.

(c) Globalisation and the pervasiveness of the law of one price

A possible third factor behind current price trends relates to the rapid expansion of the range of globally traded output (in contrast to efficiency gains within some pre-defined range). In the past it was common to observe more rapid domestic inflation in economies enjoying faster productivity growth, as wages rose and the prices of non-tradables accelerated, dragging up the consumer price index. This mechanism, based on an assumed clear analytic distinction between price behaviour of tradables and non-tradables, may still be at work, but it may not be as powerful as it used to be. Not only has the scope for productivity gains probably spread wider than the sectors – mainly manufacturing – usually typified as the beneficiaries, but also the range of tradables has been expanding relative to that of non-tradables. While it has long been acknowledged that progressively more *goods* are becoming tradable because of, for example, advances in freight transportation, the revolution in respect of *services* may now be more significant.

Thus, many services which were in the past produced only in the country where they were consumed can nowadays be out-sourced offshore or accessed from somewhere else in the world at the click of a mouse – back-office processing, multi-functional call-centre services, legal advice, logistics management, design services for anything from clothing to buildings, and even certain forms of medical consultation or education, to name but a few. Moreover, buyers of services increasingly elect to travel elsewhere to consume them. Thus the international price elasticity of a wedding ceremony, a game of golf, hospital or health spa treatment, or conference facilities is ever rising. Soon there will remain only very few location-specific activities – heritage tourism perhaps, but even that is not immune from the pressure of the law of one price, if one considers the competing heritage sites around the world.

There is evidence in Hong Kong of the impact of this process of increasingly broad-based globalisation, and it is doubtless happening elsewhere too. Liberalisation of trade policies and the achievements of the WTO will also have contributed. In sum, prices are being driven down by both productivity gains and by the expansion and intensification of competition across an ever larger range of sectors and countries. This may explain why some price surprises on the macro-policy front in the recent past have been on the downside.

4 For the UK, the peak-to-trough comparison would be 1873-95, during which the average compound deflation rate was 1.7% pa.

5 Daryl Ho and Lu Dai of the HKMA Research Department researched the historical data.

However, if central banks can digest this ingredient, there is no reason why they should be more than temporarily knocked off course. It remains within the power of monetary authorities, if they so wish, to produce inflation or pre-empt deflation, although the task may be the more difficult if action is delayed to the point where the liquidity trap manifests itself.

Hong Kong

In Hong Kong, other contributors to deflation over the past few years have been the general strength of the US dollar and the process of price equalisation across the border with Mainland China, although both the IMF and the HKMA have found that this latter effect is rather weaker overall than a few well publicised examples might lead one to believe.[6]

Hong Kong's deflation, of some 12% in CPI terms over the four years to April 2002, seems, however, to be considerably more than could be accounted for by essentially non-cyclical factors, whether of global or local origin. The implication is that much of Hong Kong's deflation has been cyclical. To what extent may the currency board regime have been responsible for this cycle?

About half of the fall in the CPI can be attributed to a collapse of property prices, which feed through both directly and indirectly to the CPI. This in turn was largely the result of the bursting of a previous asset price bubble. This is the part of Hong Kong's deflation which may appear most obviously to be linked to domestic monetary conditions rather than to any global cyclical factors. However, although it is clear that monetary conditions in Hong Kong were, as a consequence of being tied to those in the USA through the currency board mechanism, looser during the mid-1990s than one might ideally have wished, and although empirical research suggests that there is a relationship between the property cycle and interest rates, this relationship is not found to be a particularly robust or powerful one. There were other factors contributing to the developing property price bubble in the mid-1990s, such as the strong overall performance of the economy, linked to rapid development in Mainland China; some euphoria ahead of the return of Hong Kong to China in 1997; demographics; and the impact of local land release and public housing policies.[7] The cessation or reversal of such influences helps explain the subsequent downturn in property prices.

All in all, therefore, there is quite a range of factors which have come together to produce deflation in Hong Kong. There would be little point in asking precisely how much of deflation can be blamed on the exchange rate regime since, before answering, one would need to specify what sort of monetary policy the authorities would have pursued instead of a currency board. As noted above, in the absence of a liquidity trap (possibly a significant proviso in this age), it should be possible to choose a policy which could succeed in the narrow objective of eliminating deflation, at whatever cost or benefit in terms of other policy objectives. But the currency board regime rules out such a choice, and in this sense it cannot escape from being ascribed some significance in the explanation of Hong Kong's price deflation.

Does Price Deflation Matter?

In addressing this question, it is helpful to distinguish between price trends for goods and services on the one hand, and asset prices on the other. With regard to the former, there are two main mechanisms which may produce adverse consequences for the economy generally – the real interest rate channel and the distributional impact.

Real interest rates

Negative inflation may in certain circumstances imply undesirably high real rates. In particular, it rules out negative real interest rates (at least when measured simplistically by adjusting nominal rates for immediate past price movements), which may be deemed appropriate during a period of deflation.

6 See Jiming Ha and Kelvin Fan, "Price convergence between Hong Kong and the Mainland", *HKMA Research Memorandum*, June 2002; and Philip Schellekens, "Deflation in Hong Kong SAR", *IMF Working Paper*, forthcoming.

7 For a full analysis see Wensheng Peng, "What drives property prices in Hong Kong?", Page 19.

To what extent may real rates that are above some perceived appropriate level dampen economic activity?

There is no clear evidence that real rates of themselves have much of an influence on current expenditure on goods and services in Hong Kong. The effect might be expected to be strongest in relation to expenditure on durable goods but, since most of these are imported, the feed-through to local activity is diminished.[8]

Moreover, as regards investment spending, it is not the real interest rate calculated by reference to the CPI which is relevant, but the user cost – the nominal interest rate relative to the expected future net yield from the asset in question, adjusted for depreciation. Prices of different asset classes adjust according to market forces and the user-cost arithmetic, which may not be particularly sensitive to changes in the broader price level *per se*. In this light, it is at least questionable whether mild overall deflation would be a material impediment to investment decisions.

Distributional effects

Deflation will cause a shift between real incomes and profits, in the opposite way to inflation. Thus, if prices are driven down by competitive forces, profits are squeezed, which may impact adversely on future investment. At the same time, if nominal wages remain unchanged, labour will have a gain in real income. Such a process has been witnessed in Hong Kong, but it did little to sustain consumption because of caution over job security. After a while, both nominal pay began to adjust downwards and unemployment began to rise. Although it may still be true that many of those in work are better off (having suffered reductions in pay of less than the amount of price deflation over the four year period), many others have lost their jobs or have had to settle for lower-paid positions. Meanwhile, the reduction in real profits corresponding to the buoyancy of real wages may have dampened investment spending, although supporting empirical evidence is scarce. In general, because the degree of downward wage flexibility in Hong Kong is probably greater than elsewhere, the economy is believed to be better able than others to cope with this type of deflationary pressure and to avoid severe distributional disequilibria.

Overall, therefore, it has, in practice, proved difficult to identify what impact deflation of goods and services prices, of itself, may have had on activity in Hong Kong.

Asset prices

Deflation of asset prices is a rather different and potentially more serious issue. Hong Kong has certainly suffered some significant negative wealth effects on economic activity, not least via household expenditure, as a result of the sharp drop in property prices.

Asset price deflation also has the potential to create balance sheet problems for businesses and particularly for banks. However, one factor enabling Hong Kong to live with deflation perhaps better than some other economies is the resilience of the banking system and its ability to cope with debt deflation. A long tradition of fairly conservative prudential oversight of the banks has left them strong enough to weather the recession.

Conclusion – Lessons from the 1990s[9]

There are perhaps two main lessons from a Hong Kong perspective to have emerged from the 1990s.

First, the decade served to confirm what had already become apparent from Hong Kong's experience with a currency board in the 1980s, namely that a currency board can be a viable and, arguably, optimal regime for certain types of economy, but not all. The necessary conditions for success include sufficiently flexible costs and prices, a sound banking system, adequate fiscal discipline and the requisite foreign exchange reserves to back the monetary base, preferably free of other

8 See also "Real interest rates in Hong Kong", *HKMA Quarterly Bulletin*, August 1999.

9 The context is explained in footnote 1.

encumbrance. Not all these desiderata were satisfied in one instance of a 1990s' currency board, which has since passed into history.

The second lesson concerns the novel feature to emerge late in the 1990s and persist through to the current decade – namely deflation. After a gap of a lifetime, there has been evidence of some quite persistent downward pressures on prices globally, even if overall deflation has only emerged to a significant extent in the eastern hemisphere. It seems perfectly possible to live, as some earlier generations did, with modest deflation in prices of goods and services, and even in earnings, once one has adapted to it, even though a modest positive rate of inflation may be preferable. For Hong Kong, the hope – and reasonable expectation – is that the US economy, to whose monetary stance Hong Kong is tied, will not develop in such a way as to make the problem of deflation in Hong Kong – if that is indeed what it is – any worse.

Less tolerable are severe gyrations in asset prices. This is not a new phenomenon, but it is one which continues to pose a challenge to monetary authorities around the globe.

As regards policy regimes, the currency board has been only one of a number of factors which may have contributed to Hong Kong's deflation. The fact that other regimes may provide the authorities with means to influence the price level which are denied under a currency board, does not constitute sufficient grounds for abandoning the regime which has generally served the Hong Kong economy well and provided a long track record of disciplined monetary stability for almost twenty years.