Mr Latter gives an overview of the current monetary policy stance of Hong Kong

Address by Mr Tony Latter, a Deputy Chief Executive of the Hong Kong Monetary Authority, at the CLSA Investors' Forum in Hong Kong on 17 May 1999.

I should like to say a few words about the present stance of monetary policy in Hong Kong and its relation to the broader state of the economy.

Hong Kong has a fixed exchange rate against the US dollar. The pros and cons continue to be a focus of debate in some quarters, but I don't intend to dig over that ground yet again today. Suffice it to say that over the past fifteen years Hong Kong has enjoyed, on balance, remarkable prosperity. I happen to think that the visible and trusted monetary discipline of the exchange rate link has been a decisive contributory factor to that prosperity.

Of course, one cannot deny that there is some association between the strength of the exchange rate and the level of interest rates on the one hand, and the current recession on the other, but I would caution against adopting too short-term a horizon when drawing conclusions, and I would also suggest that some of the adjustment which we have experienced - for example in property prices - was both necessary and somewhat overdue. Perhaps I should also add that the Hong Kong dollar's stability after the depreciations of other regional currencies in 1997 probably helped to avert what might have been a spiral of further depreciations, which could have caused greater damage in the region and might even have had more painful eventual consequences for Hong Kong itself than we have in fact suffered.

Slide 2[1] shows the path of the real effective exchange rate since mid-1997. This is the trade-weighted exchange rate adjusted for differences in movements of consumer price indices. It is one of several possible measures - none of them ideal - of external competitiveness. A movement up the page denotes a loss of competitiveness. The steep loss around the time of the Asian crisis in late-1997 has been partly recovered. The setback in the earlier part of this year arose mainly from the strength of the US dollar.

But let's look at this question in a longer-term perspective. Slide 3 shows that in the 13½ years from the introduction of the linked exchange rate up to mid-1997 the real rate appreciated on average by 4% a year; in the period since then the real appreciation has averaged 4½% a year.

On this basis one might say that we are scarcely off track at all, from what appears to have been a secular trend of real appreciation of the currency. But others might argue that the structural changes of the eighties and nineties which were consistent with an appreciating real rate because of much more rapid productivity gains in the tradable than in the non-tradable sectors, cannot be repeated, so that the assumption of a continuing secular uptrend is invalid. On that view, the net appreciation over the past couple of years may be deemed to have dragged us away from our preferred path.

It is hard to judge where the proper balance of these views lies. I recall how, 15-20 years ago, the doom merchants were prophesying the end of Hong Kong's long run of growth because we were rapidly losing competitiveness in much of manufacturing. Presumably they did not

[1] Slides are not included in this text document.

foresee the remarkable extent to which the service sector would develop as an alternative wealth-generating lynchpin of the economy. Now, the next generation of doom merchants is prophesying imminent disaster as competitiveness in certain parts of the service sector appears to have been eroded. Will they be wrong again? Have they failed to appreciate the true workings of the market economy and comparative advantage? Do they not realise how difficult it is to foretell exactly how an economy will evolve, even though the evolution is taking place right under our noses? Indeed, as we sit here worrying about it, there are people out there who are busy exploiting niches and opportunities which will mould the future structure of the economy. We can try to facilitate that process, or even to guide particular aspects which we reasonably expect to be important (eg the cyberport), but there will always be surprises.

In any analysis of competitiveness there is inevitably scope for argument about the appropriateness of the statistics one is using. I believe that in the current Hong Kong conjuncture the popular measures such as the real exchange rate may have been lagging somewhat behind the recovery of competitiveness that may have actually occurred. Business decisions are influenced more by marginal prices and expectations of future prices, than by prevailing average prices; yet the measure of rentals which enters the CPI is typically based on an average of outstanding contracts and not the price at which new contracts are being struck - which have over the past year or so fallen much more steeply. Thus, when thinking of business decisions, even assuming that residential rentals are a satisfactory proxy for rental costs affecting business, some adjustment for the marginal/average discrepancy may be needed at times when that discrepancy is significant - as it certainly is when one is at or near turning points in the rental cycle. Please be assured that I am not criticising the construction of the CPI, which is, so far as I am able to judge, absolutely appropriate in terms of arriving at an overall cost-of-living index, but I do suggest that some qualifications may be needed if it is to be used in other analysis, such as that of business decisions which we are discussing here.

Let me turn now to interest rates. Real rates have been high, at least as measured on the backward-looking basis in slide 4 (ie nominal rates less recorded inflation over the preceding twelve months). This is the arithmetic result of nominal rates which are very much dictated by US rates and recent deflation of prices in Hong Kong. US rates are being held up in part by the extremely buoyant US economy, and you will see from slide 6 that the Hong Kong economy is out of phase with the US, on the downside, to a greater extent than at any time since our exchange rate link was established. The only comparable divergence was in the 1980s, and that was on the upside, when we experienced - in complete contrast to today - uncomfortably rapid inflation and negative real interest rates.

But tight monetary policy is being balanced by a more relaxed fiscal stance (slide 7), as defined by the size of the budget balance relative to GDP. This is a reversal of the more common position in Hong Kong of relatively loose monetary and tight fiscal policy. The chart confirms that historically, as one might expect, there has generally been an offsetting balance of these two policy components.

I think, nevertheless, that there is a tendency to exaggerate the tightness of monetary policy at the present time. This happens because of too simplistic an approach to measuring real interest rates and assessing their influence. I can best illustrate this by reference to the illustration in slide 8. As at April last year, 12-month HIBOR was 8.0%. Looking back over the preceding 12 months (ie April 1997 to April 1998), inflation had been 4.7%, so at that time (April 1998) the commonplace measure of the real interest rate would have yielded 3.3%. A more sophisticated method would have been to take the forecast for inflation over the coming year (April 1998 to April 1999), which was then 4.2% (I have based this on an interpolation from the annual figures from the consensus of private sector forecasters at that time), yielding a somewhat lower real rate of 3.8%. But that forecast of inflation turned out to be wildly wrong; the actual outturn for the 12 months April 1998 to April 1999 was minus 2.6%, which means that the real rate actually realised, and thus experienced by someone borrowing or lending for twelve months at HIBOR, was, on the CPI basis, 10.6%. On top of that, the marginal/average adjustment for rentals to which I referred earlier would have tended to raise the realised real rate even further, because the prices influencing business decisions probably fell by more than the CPI. In sum, what started as a headline real rate of 3.3% ended up as a rate well in excess of 10½%. Businesses would have been affected by the factors responsible for the difference between these figures, but would not have been able to anticipate all of them.

If we move on to April this year, the position is rather different. The backward-looking real rate, which tends to be the one which most people take as their guide when clamouring about oppressive monetary policy, is indeed high at 8.9% - again taking 12-month HIBOR as the base. But because expectations are that prices are now going to move up rather than down, the forward-looking measure, based on consensus forecasts (from the private sector) of what the published CPI will show, yields much less, 5.6%. In addition, the marginal/average adjustment may now have turned the corner, since business decision-takers may be facing prices that will rise by more than the recorded CPI, in which case real interest rates will now be perceived as lower than 5.6%. Perceptions may still be of a figure which is above the 3-4% range, which is often regarded as a global norm; but perceptions vary, and there may be some who visualise a lower figure. We are of course not yet in a position to observe the actual outcome; there may, as last year, be surprises in store. My examples have been based on 12-month HIBOR; there may, of course, be benchmarks higher or lower than this reference point which are more relevant to individual decisions.

I hope that I have succeeded in demonstrating that the measurement of real interest rates is rather more complex than may appear at first sight, and is dependent also on the context.

If you were to look at only the popular measure of the real rate - the nominal rate deflated by a measure of past inflation - then the recovery in asset prices in Hong Kong over recent months would seem inexplicable, because real rates would have appeared so high. The recovery in asset prices would, however, be consistent with a reduction in perceived real rates - which is in fact what I am suggesting has occurred, on a fairly significant scale, as expectations of inflation have probably become positive while headline recorded inflation remains negative. For those who see some downside in all of this from the implication in the consensus forecasts that general inflation is now expected to resume, it is worth noting that the forecast magnitude is only very modest.

I would not pretend that every piece of evidence unequivocally supports my thesis today. For instance, the continuing lethargy of bank lending to business in Hong Kong might suggest that high real interest rates remain a deterrent to borrowing and investment. However, I suspect that, while that may well have been the case a little while ago, we are now in a period where decisions are being more influenced by confidence factors relating to the broader economic situation than by interest rates per se, although interest rates do of course remain important.

I have pointed to elements of the present economic conjuncture - namely, competitiveness and interest rates - where the position may not be so bleak as painted by some. But I do not deny that we face tough challenges and I note that the consensus for the immediate outlook is for no more than an unspectacular recovery. I have no brief today to try to talk up our economic prospects. My wish is rather to contribute analytically to the discussion of those prospects. The only certainty is that the future is always uncertain.