Property prices, inflation, and policy challenges in Hong Kong

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Hong Kong plays various important roles in the Asia-Pacific region. One key role is to serve as an entrepôt of trade and fund flows; the Special Administrative Region is a bridge between Mainland China and the rest of the world. Hong Kong has developed into a highly service-based economy, with 93% of GDP contributed by service industries. In terms of both output and inflation, the Hong Kong property market is an important driver of macroeconomic outcomes. In 2010, real estate services accounted for 5% of GDP, while the ownership of premises amounted to 11% of GDP. At the same time, housing costs comprised 31.7% of the Hong Kong CPI basket.

In terms of macroeconomic policy setting, the Hong Kong Monetary Authority has a unique policy framework that has served the economy well. Capital flows freely in and out of the Region. The stable external value of the currency, set in the context of the Linked Exchange Rate system through a currency board arrangement, has also contributed to microeconomic efficiency gains. Overall, macroeconomic policy in Hong Kong puts emphasis on long-term (through-the-cycle) stability rather than demand management.

Table 1

Drivers of economic fluctuations in Hong Kong

Variance Decomposition of Shocks: Impact on Hong Kong

	Output			Price		
	US	CN	HK	US	CN	HK
1 quarter	16.26	18.70	65.04	23.44	1.73	74.83
1 year	40.03	16.01	43.96	22.22	12.22	65.56
5 years	41.70	17.36	40.95	33.08	22.05	44.86
10 years	43.71	16.79	39.50	36.42	21.26	42.32

Notes: The data sample covers the period from the first quarter of 1995 to the third quarter of 2010. The structural VAR system contains seven variables: CPI inflation and real GDP growth in the US, Mainland China and Hong Kong, and the three-month US Treasury bill rate. For identification, assumptions were made on the transmissions of economic shocks based on the relative sizes of the three economies. The economic developments in the global market, represented by the US factors, will influence the Mainland and Hong Kong, but not vice-versa. Similarly, the economic developments on the Mainland can influence Hong Kong but not the opposite.

Empirical evidence confirms the relative importance of Mainland China and global factors in driving macroeconomic developments in Hong Kong. Table 1 shows the results from a structural vector autoregressive model that contains macroeconomic variables from the United States, Mainland China and Hong Kong. The results suggest that while in the short

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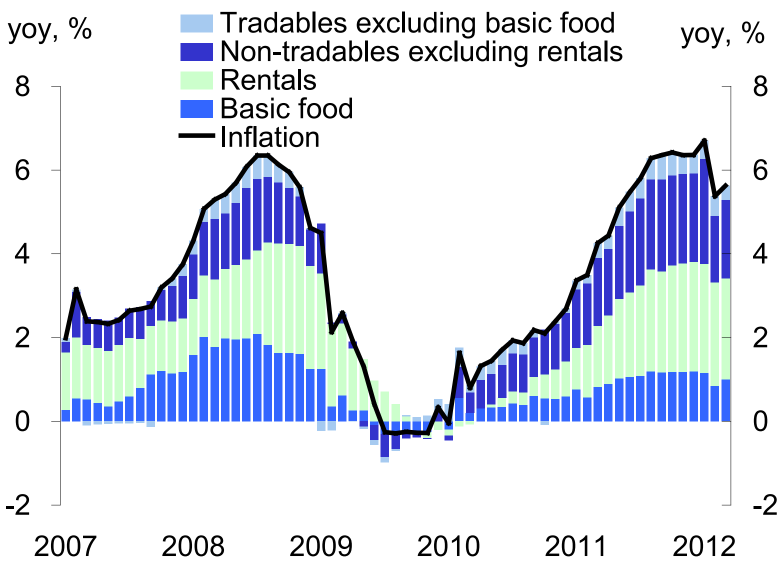
run both output and price dynamics in Hong Kong are mainly driven by domestic shocks, the importance of shocks from the United States and Mainland China strongly increases in the medium and long run. In terms of inflation fluctuations, Hong Kong's own shocks are the dominant contributors to price dynamics even in the long run.

One local factor in particular – rental prices – has been a significant driver of inflation dynamics in Hong Kong. As shown in Figure 1, the contribution of housing rentals was large during the two recent upturns in inflation cycles. As CPI inflation peaked in mid-2008 and early 2012, the rental component alone accounted for roughly 2 percentage points of overall CPI inflation around both inflation peaks. The increase in rentals has been accompanied by increases in inflation of other non-tradables, while inflation in tradables excluding basic food has remained moderate.

Figure 1

Growth in components of CPI inflation



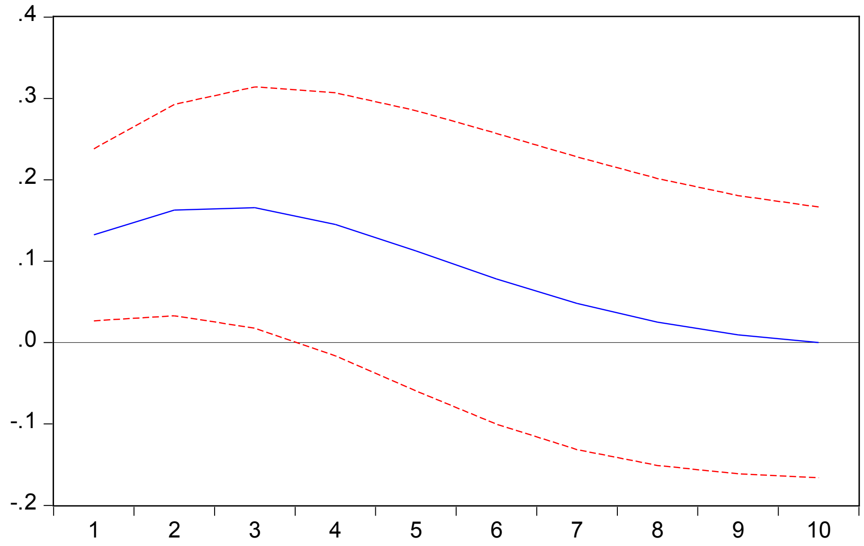
Moreover, property price developments influence the non-rental components of Hong Kong's consumer prices. Figure 2 shows the estimated response of the non-rental component of the Hong Kong composite CPI to a shock in local property price inflation. There is an immediate increase in the non-rental component following a positive shock to Hong Kong's property price inflation. The impact of the shock is statistically significant for approximately three quarters and then dies out slowly.

These price dynamics – housing prices influencing CPI movements through both its rental and non-rental components – underscore the importance of macroprudential tools in Hong Kong's policy framework. The Hong Kong Monetary Authority has been using macroprudential policies to prevent bank credit from fuelling property price bubbles and to ensure that banks and their customers have a sufficient cushion on their balance sheets to survive volatilities in property prices. These policies do not aim at targeting property prices but may help to dampen the amplitude of property price cycles and to prevent the collateral damage that other, more blunt policies might cause.

Figure 2

Impact of property prices on non-rental components of consumer prices

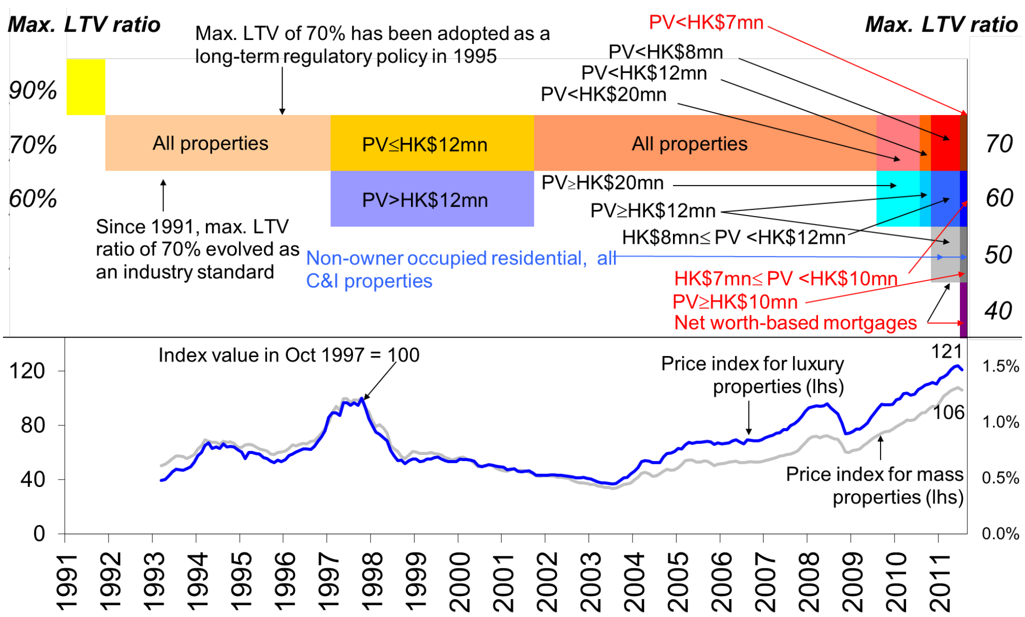
Response of CCPIEX_QOQ to Cholesky One S.D. PC1_PP_QOQ Innovation



Indeed, over the past two decades, the Hong Kong Monetary Authority has used loan-to-value ratios (LTVs) as one type of targeted policy tool to manage banks' credit exposures to the property market and lean against the amplitude of property price cycles. Figure 3 shows how this policy has evolved over time. Hong Kong started off in the early 1990s with a maximum loan-to-value ratio of 70% for all property types, introducing more differentiated ratios over time depending on the property type and its value. Thus, the policy has expanded in terms of both its scale and its scope. In recent years, the use of LTVs has become more intensive as a means to address the strong upward pressure on the housing market.

Figure 3

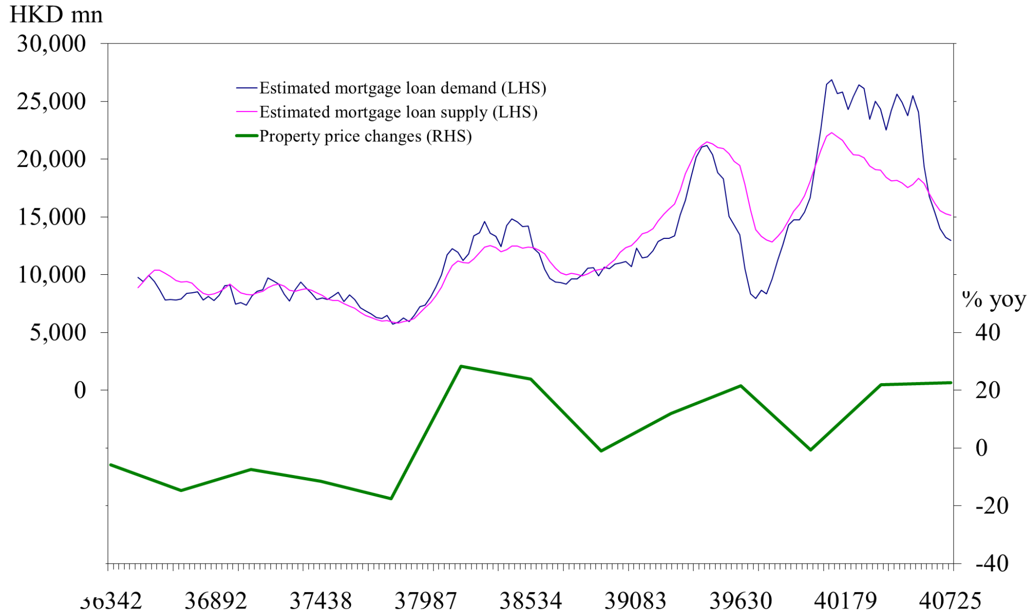
History of loan-to-value (LTV) policies



In an important sense, macroprudential policies are effective tools to limit the quantity of leverage in an economy like Hong Kong. In terms of loan supply and demand, the supply of mortgage loans has been effectively constrained by the LTVs and this helped lean against property price dynamics, as shown in Figure 4. In other words, if the demand for mortgage loans had been fully satisfied by banks, then upward pressures on property prices would have been even higher. These policy actions have shown that managing the quantity of leverage in the system has contributed to financial stability in Hong Kong.

Figure 4

Effect of LTV caps on property prices



Overall, Hong Kong's experience shows that simple and transparent limits on leverage in residential mortgages have served to prevent bank credit from fuelling asset prices and helped dampen the amplitude of property price cycles. By leaning against property price fluctuations, they have helped reduce the swings in overall CPI inflation. The adopted macroprudential measures have therefore contributed to both macroeconomic and financial stability.