Box 1.1

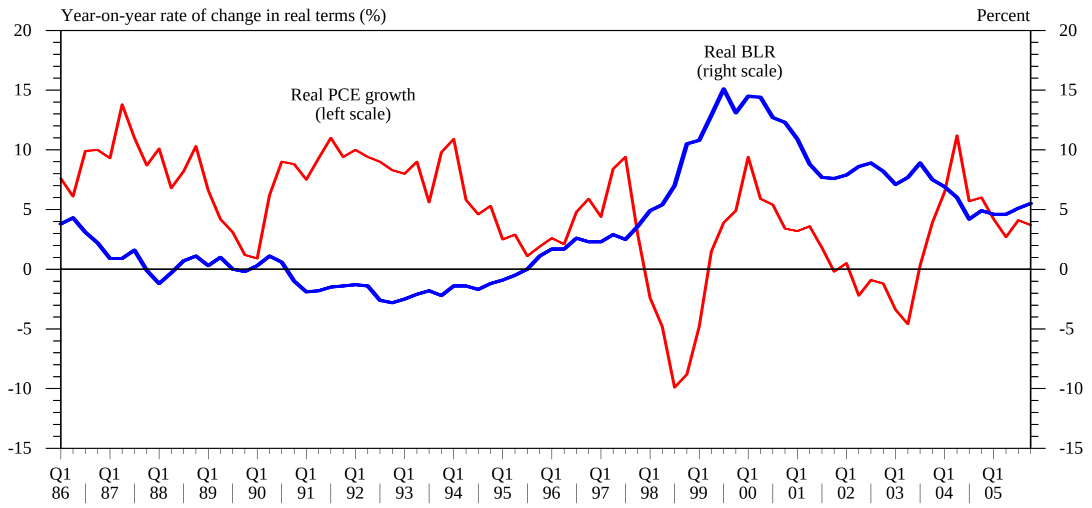
Impact of higher interest rates on the Hong Kong economy

By mid-February 2006, the US Federal Reserve had raised the Fed Funds Target Rate by a cumulative of 3.5 percentage points since June 2004 to 4.5%, with a view to removing the accommodative monetary policy stance so as to contain inflation pressures that come from high oil prices and strong economic growth. Under the linked exchange rate system, Hong Kong's interest rates have largely followed the movements of their US counterparts. As a result, the best lending rates (BLR) charged by major local banks rose from 5% in mid-March 2005 to 7.75 – 8% in mid-February 2006.

Against the background of the successive interest rate hikes, there are concerns about the possible dampening impact on the Hong Kong economy. Specifically, there are concerns that local investment would be curtailed as the interest cost of the business community has been raised and investment confidence dented. Also, there could be some negative impact on consumer demand, if the interest rate hikes induce downward adjustment in the local asset markets and hence trigger negative wealth effects. Yet apart from some cooling off of the property market, which might have put a dent on consumer spending growth, the Hong Kong economy had by and large weathered the effects of higher interest rates rather well up to the fourth quarter of 2005.

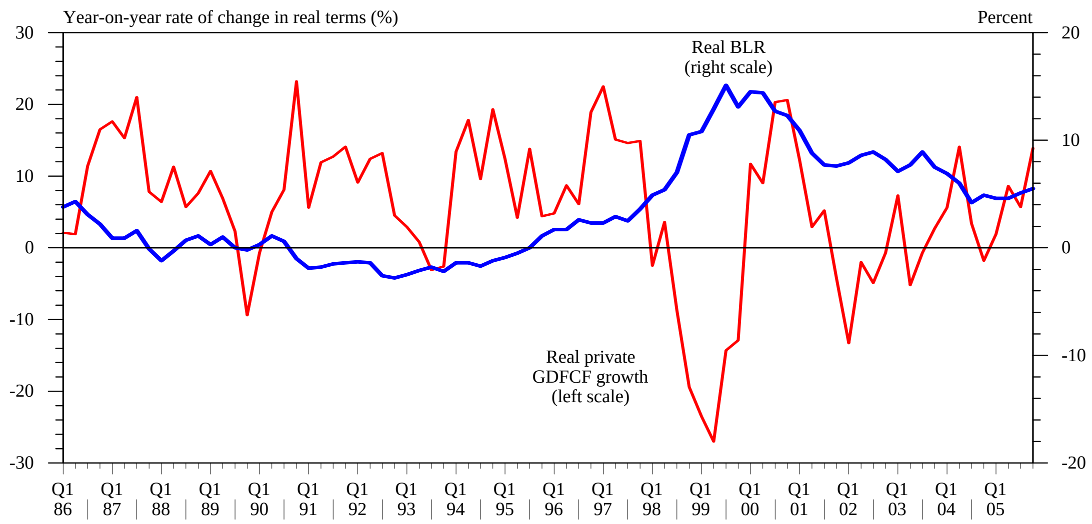
An examination of the historical trend of real interest rates and Hong Kong's GDP and its domestic demand components, however, does not reveal any definite pattern of how real interest rate movements would impact on the economy in a very significant way. This may not be at all surprising given that the levels of indebtedness of the household and corporate sectors are low in Hong Kong, as suggested by the persistently high savings ratio and the strong net external financial asset position of Hong Kong. Also, it is worth noting that the interest rate policy of the US Federal Reserve is to forestall the inflation risk that may arise from a buoyant US economy. Thus a higher interest rate has often been a reflection of the strong state of the US economy, which has been the key driving force of global economic growth. Thus the negative impacts arising from higher interest rates have often been diluted by other positive economic developments.

Real BLR vs real private consumption growth



Box 1.1 (cont'd)

Real BLR vs real private investment growth



In fact, empirical results suggest that domestic demand in Hong Kong is affected more by changes in income than by the level of real interest rates. Correlation analysis indicates a much higher correlation between domestic demand and GDP, and between domestic demand and total exports of goods and services, which are usually the main drivers of economic growth. Granger causality tests also confirm strong evidence of causality running from GDP and exports of goods and services to domestic demand, though with a time lag of around three quarters. This accords well with the a priori reasoning that income and external trade are much more important determinants in influencing the state of domestic demand in Hong Kong.

The current interest rate up-cycle has led to some consolidation in the local housing market during the second half of 2005. This could have some mild dampening effects on consumption demand through the negative wealth effect. The effects may be even felt more fully in 2006. Yet the main concern stemming from the US interest rate up-cycle is that it would work to dampen demand in the US economy, thereby curtailing Hong Kong's export growth and hence Hong Kong's GDP growth. A slow-down in the US economy, given its prominence as the key growth engine in the global economy, would have consequential impacts on demand in the global and regional economies. There would thus be not only a direct impact on Hong Kong's exports to the US, but also an indirect impact on Hong Kong's exports to the rest of the world. The moderation in our export and income growth would also have a spillover effect on the performance of the domestic sector.

Nevertheless, the current levels of interest rates are not regarded as high by historical standards. It is widely expected that the Federal Reserve is aiming at setting the target rate at the 'neutral' level, which will neither stimulate nor constrain the economic growth of the US while keeping inflation in check. The market also expects the current US interest rate up-cycle may be near its end. If so, the slowdown in US economic growth may be rather moderate in the near term, and in such an event the consequential impact on the Hong Kong economy is likely to be of a manageable scale. From a longer-term perspective, maintaining price stability in the US would foster steady economic growth in the US, which is conducive to a sustainable growth in the global economy over the medium to longer term, in turn to the benefit of the Hong Kong economy.