ECONOMIC REVIEW (A Monthly Issue) July, 2015

BANK OF CHINA (HONG KONG) LIMITED Economics & Strategic Planning Department http://www.bochk.com

Hong Kong Has Nothing to Fear about Rate Hikes

Tristan Zhuo, Senior Economist

Six years after the great recession ended, the Fed's zero interest rate policy (ZIRP) remains intact. At long last though, as more and more FOMC policymakers have lent their support to raising rates, interest rate normalization is no longer a distant prospect. That said, due to the tepid recovery and mild inflation in the U.S., the pace of rate hikes will be fairly slow, and monetary policy will continue to be accommodative for an extended period of time.

Hong Kong's interest rate environment is largely determined by the Fed, it is thus only natural to be concerned with the impacts of the first rate hike in 9 years. After all, it was a very different world back then. There were no smartphones; Greek and German bond yields were virtually identical; the Hong Kong dollar was more expensive than the RMB. In retrospect, ultra-loose monetary policy was hardly appropriate for Hong Kong's relatively robust economy to begin with. Rate hikes should be welcomed with open arms, not feared.

Resistance to monetary tightening will be futile

Some believe that Hong Kong do not have to follow suit in the event of a Fed rate hike thanks to abundant funds and a gigantic aggregate balance of the banking system. Granted, interest rates may not go up simultaneously in Hong Kong and the U.S. However, any difference in timing is likely to be inconsequential for all intents and purposes.

Under the linked exchange rate system and the currency board regime, interest rate adjustments are indispensable to maintaining the peg between the Hong Kong dollar and the greenback. The sheer magnitude of the aggregate balance stemmed from capital inflow triggered by the Fed's three rounds of quantitative easing. The HKMA had to sell Hong Kong dollars as the currency faced upward pressure, thereby expanding the monetary base, lowering interest rates, and maintaining the peg.

When the Fed tightens monetary policy, the opposite will occur. If interest rates in Hong Kong remain unchanged, the resulting capital outflow will exert downward pressure on the Hong Kong dollar. Under the linked exchange rate mechanism, the HKMA will then have to buy Hong Kong dollars, reducing the monetary base and lifting interest rates. In other words, interest rates in Hong Kong and the U.S. almost always move in lockstep. Any delay in such transmission mechanism will likely be immaterial and negligible.

Hong Kong's economy can easily withstand rate hikes

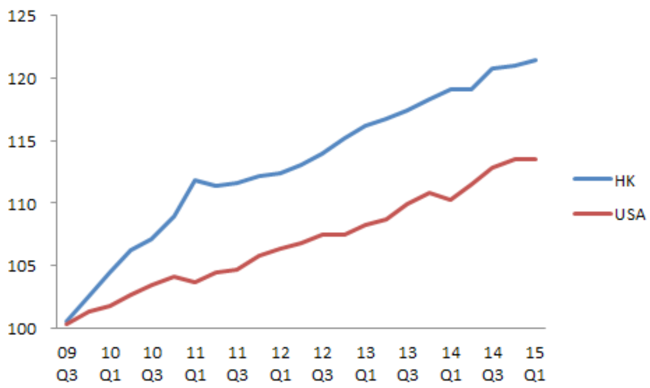
For Hong Kong's economy, ZIRP has long passed its sell-by date. Indeed, interest rate normalization will help mitigate the disconnection between monetary conditions and macroeconomic performance in Hong Kong.

First, in spite of a recent slowdown, Hong Kong's economic growth still outpaces that of the U.S. and most developed economies. From the inception of the recovery in the third quarter of 2009 to the first quarter of 2015, Hong Kong's real GDP grew on average at 3.3% per annum, 1.2 percentage points stronger than America's 2.1% annual growth in the same period. Ultra-loose monetary policy is clearly not an appropriate prescription for Hong Kong. The Taylor rule, a formula that calculates the neutral benchmark interest rate for a given economy taking into account its unemployment and inflation metrics, sheds light on Hong Kong's predicament. Using the parameters computed by the San Francisco Fed, the Taylor rule can be expressed thusly.

$$\text{Benchmark interest rate} = \text{Neutral real rate (2\%)} + \text{Inflation} + [0.5 \times (\text{inflation} - \text{inflation target})] + (\text{NAIRU} - \text{unemployment rate})$$

Hong Kong does not have an inflation target, nor is there a consensus estimate on the non-accelerating inflation rate of unemployment (NAIRU). That being said, for the purposes of approximation, a 3% inflation target and a 4% NAIRU are probably reasonable guesstimates. Plugging these values and the latest underlying inflation rate and jobless rate into the equation produces a benchmark interest rate of 5.2%. Obviously, a Fed funds rate liftoff would not hurt Hong Kong's economy.

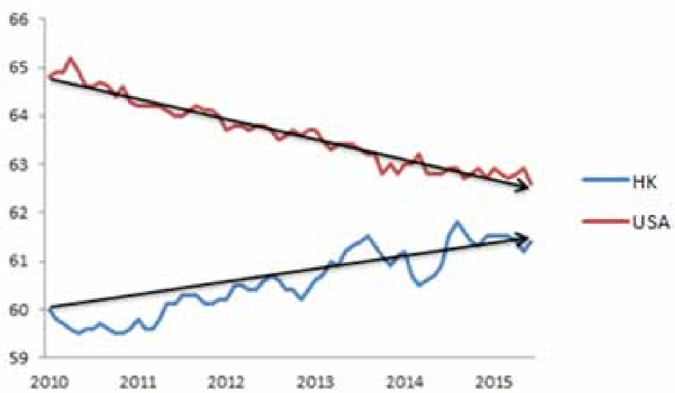
Chart #1 Hong Kong's growth outpaces that of the U.S.
(Real GDP, mid 2009 = 100)



Sources: Census and Statistics Department, Bureau of Economic Analysis, BOCHK Research

Second, Hong Kong's buoyant labor market remains at full employment, with the unemployment rate coming in at 3.2% for three consecutive months. Unlike the dubious quality of the recovery in the U.S., the stellar performance of Hong Kong's labor market has been driven by genuine improvement in jobs and the labor force. In America, the seemingly inexorable decline in the unemployment rate is largely attributable to falling labor market participation, whereas participation trended upwards in Hong Kong. The tight labor market is undoubtedly ready for interest rate normalization.

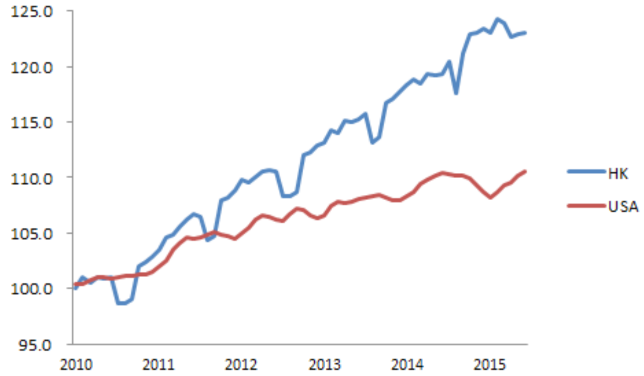
Chart #2 Hong Kong's labor participation rate trended upwards (%)



Sources: Census and Statistics Department, Bureau of Labor Statistics, BOCHK Research

Third, rate hikes will help ease inflation, which remains far higher than in most advanced economies. In the past year, the U.S., the U.K., the Euro-zone, and even Singapore have all experienced outright deflation, while Hong Kong's composite inflation rate has been stubbornly over 3%. Persistent annual inflation in the low single digit can have rather considerable cumulative effects. Since 2010, Hong Kong's composite consumer price index has gone up by 23.1%, more than double the 10.5% increase in the U.S. Put another way, in the past five and a half years, the purchasing power of the Hong Kong dollar declined by 18.8%. Rising interest rates will slow inflation and reward savers, thereby providing relief for people struggling to make ends meet.

Chart #3: Hong Kong's consumer price index rose a lot faster than that of the U.S. (2009 yearend = 100)



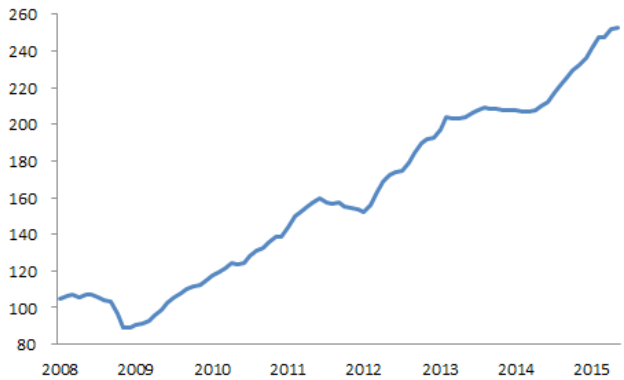
Sources: Census and Statistics Department, Bureau of Labor Statistics, BOCHK Research

In macroeconomic analysis, overall economic activity, the labor market, and consumer prices are the three most important aspects. As Hong Kong outperforms the U.S. in the first two areas while enduring higher inflation, interest rate normalization is long overdue. Crisis-era monetary policy should have expired years ago in the U.S., let alone Hong Kong.

Rate hikes will tame property prices

Meanwhile, rate hikes should help slow the meteoric rise in Hong Kong's property prices. Prices of private residential properties bottomed at the end of 2008 and has been on a tear ever since. From 2009 to May of 2015, property prices soared by 185% in spite of a series of demand management measures launched by the government. The root cause of the euphoric property market lies in ultra-low interest rates, which will not change until the Fed initiate a liftoff.

Chart #4 Rock-bottom interest rates drove property prices ever higher (2007 yearend = 100)



Sources: Rating and Valuation Department, BOCHK Research

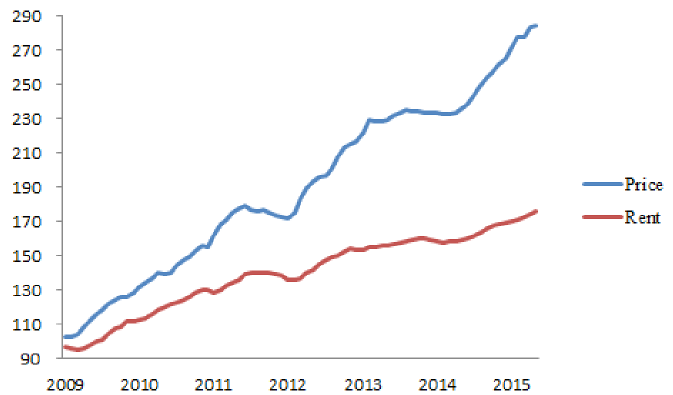
There are primarily two reasons why higher interest rates will lead to weaker momentum for property prices. **For one, affordability will deteriorate.** The typical apartment in Hong Kong now costs 15 times the median annual household income. Judging by this metric alone, many prospective homeowners should have been priced out of the market altogether. However, due to historically low interest rates, the rise in mortgage payment as a percentage of household income has been relatively moderate. According to the HKMA, the income-gearing ratio is now approaching 70%, considerably higher than the long-term average of 50% but far below the 110% peak in 1997. Mortgage payments are extremely sensitive to the interest rate environment. Tighter monetary policy will inevitably make apartments less affordable and put downward pressure on prices.

For another, rental yields will become a lot less attractive when interest rates start to rise. In the first quarter of this year, the yield on Class C properties (those between 70 and 99.9 square meters) dropped to a record-low of 2.6%. At first glance, this meagre return is nothing to write home about. But the desirability of apparently low rental yields immediately becomes obvious when one considers rock-bottom interest rates. Since records began in 1987, the difference between rental yields on Class C private properties and the Fed funds rate has averaged 1.3%. In contrast, the yield at present is 2.5 percentage points higher than the Fed funds rate. In the age of ZIRP, nominal yields on Hong Kong properties are indeed far more appealing than they first appear.

That will no longer hold true when interest rate normalization commences. Since 2009, property prices have risen much faster than rents. During the past six and a half years, the cumulative gains for prices and rents are 185% and 76%, respectively. When benchmark interest rates finally go up, there are only three ways that rental yields can maintain their advantage: rents rise; prices drop; rents outpace prices. Given the spectacular rise in prices and the relatively moderate increase in rents, prices may have to bear much of the burden of adjustment. Besides, from a valuation standpoint, the price of a property represents the net present value of future rental income. When interest rates are low, future rental receipts are favorably discounted, and properties command a high value. By the same token, rising interest rates will increase the discount rate and put downward pressure on prices.

Looking ahead, moderate rate hikes will not trigger a plunge in Hong Kong's housing prices. But as interest rate normalization approaches, the extraordinary bull market may be nearing an end.

Chart #5 Private residential property prices rose much faster than rents (2008 yearend = 100)



Sources: Rating and Valuation Department, BOCHK Research

In summary, the Taylor rule suggests that ZIRP is far from appropriate for Hong Kong's relatively robust economy. In fact, Hong Kong should cheer for, not fear, interest rate normalization. Since 2009, soaring property prices have been an intractable issue, with ultra-low interest rates being the dominant determinant that outweighs the influence of all other factors. Rising interest rates should help put a lid on price gains. Rate hikes are long overdue in the U.S. and even more so in Hong Kong. Bring it on!

主要經濟指標 (Key Economic Indicators)

一 . 本地生產總值 GDP	**2013**	**2014**	**2014/Q4**	**2015/Q1**
總量 (億元) GDP($100 Million)	20,961	21,446	6,127	5,724
升幅 (%) Change(%)	2.9	2.3	2.4	2.1
二 . 對外貿易 External Trade	**2013**	**2014**	**2015/5**	**2015/1-5**
外貿總值 (億元) Total trade($100 Million)				
港產品出口 Domestic exports	544	553	43	199
轉口 Re-exports	35,053	36,175	2,876	13,998
總出口 Total exports	35,597	36,728	2,918	14,197
進口 Total imports	40,607	42,190	3,319	16,167
貿易差額 Trade balance	-5,010	-5,463	-401	-1,970
年增長率 (%) YOY Growth(%)				
港產品出口 Domestic exports	-7.6	1.7	-19.6	-13
轉口 Re-exports	3.8	3.2	-4.4	1
總出口 Total exports	3.6	3.2	-4.6	0.8
進口 Imports	3.8	3.9	-4.7	-0.8
三 . 消費物價 Consumer Price			**2015/6**	**2015/1-6**
綜合消費物價升幅 (%) Change in Composite CPI(%)	4.3	4.4	3.1	3.7
四 . 樓宇買賣 Sale & Purchase of Building Units				
合約宗數 (宗) No. of agreements	70,503	81,489	7,993	43,636
年升幅 (%) Change(%)	-29.9	15.6	8	27.6
五 . 勞動就業 Employment			**2015/3-2015/5**	**2015/4-2015/6**
失業人數 (萬人) Unemployed(ten thousands)	11.84	14.95	12.8	13
失業率 (%) Unemployment rate(%)	3.4	3.2	3.2	3.2
就業不足率 (%) Underemployment rate(%)	1.5	1.5	1.4	1.4
六 . 零售市場 Retail Market			**2015/5**	**2015/1-5**
零售額升幅 (%) Change in value of total sales(%)	11.0	-0.2	-0.1	-1.8
零售量升幅 (%) Change in volume of total sales(%)	10.6	0.6	4.6	1.3
七 . 訪港遊客 Visitors				
總人數 (萬人次) arrivals (ten thousands)	5,430	6,077	476	2,497
年升幅 (%) Change(%)	11.7	11.9	3.6	3.9
八 . 金融市場 Financial Market			**2015/5**	**2015/6**
港幣匯價 (US$100=HK$) H.K. Dollar Exchange Rate (US$100 = HK$)	775.4	775.6	775.2	775.2
貨幣供應量升幅 (%) change in Money Supply(%)			**2015/4**	**2015/5**
M1	9.7	13	18	23.6
M2	12.3	9.5	10.3	9.1
M3	12.4	9.6	10.4	9.1
存款升幅 (%) Change in deposits(%)				
總存款 Total deposits	10.6	9.7	11.8	10.9
港元存款 In HK$	5.1	9.3	9.1	11.1
外幣存款 In foreign currency	16.2	10.1	8.8	6.9
放款升幅 (%) in loans & advances(%)				
總放款 Total loans & advances	16.0	12.7	8.0	7.3
當地放款 use in HK	13.8	12.1	5.4	4.6
海外放款 use outside HK	21.4	14.2	14.3	14
貿易有關放款 Trade financing	43.8	-1.4	-12.1	-11.9
最優惠貸款利率 (%) Best lending rate (%)	5.0000	5.0000	5.0000	5.0000
恆生指數 Hang Seng index	23,306	23,605	24,901	27,424