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**Fourth Issue
(February 2004)**

Welcome to the fourth issue of the Hong Kong Institute for Monetary Research (the Institute) Newsletter, which gives you information about recent and upcoming events.

The Institute was established by the Hong Kong Monetary Authority (HKMA) in August 1999 to conduct and support research on issues in monetary policy, banking and finance that are of strategic importance to Hong Kong and the Asian region.

Highlights of this issue:

Two Workshops in 2003.

Interviews with Michael Kumhof – visiting Research Fellow at the Institute.

Conference: Deflation, Pegs and Capital Flows.

Recent publications and coming activities of the Institute.

Hong Kong Institute for Monetary Research -- *Newsletter*

Change of Address

From 18 November 2003, the address of the Institute for all correspondence is:

55th Floor
Two International Finance Centre
8 Finance Street
Central, Hong Kong

All email addresses, telephone and fax numbers remain unchanged.

Two Workshops in 2003

Summer Workshop

The Institute organized a Summer Workshop on money and finance on 27 August 2003. Three speakers, Charles Goodhart (London School of Economics and Political Science), Hans Genberg (Graduate Institute of International Studies, Geneva) and Michael Kumhof (Stanford University) presented papers. It was well attended by more than forty participants. The papers are available on the Institute's website.



Charles Goodhart at the Summer Workshop

Australasian Macroeconomics Workshop

The 8th Annual Australasian Macroeconomics Workshop was hosted by the Institute in Hong Kong on 22 and 23 September 2003. The Workshop moved to this part of Asia for the first time, after being hosted in New Zealand and Australia since 1996. Joseph Yam, Chairman of the HKIMR Board of Directors, gave opening remarks. Thirty-three papers were presented from participants from various universities and central banks and are available on the Institute's website.



Participants at the workshop dinner



From left to right, Vincent Lee, Joseph Yam, S.K. Tsang and Mark Crosby

Visiting Fellow – Michael Kumhof

Michael Kumhof from Stanford University visited the Institute from July to September 2003 to work on a research project entitled “Inflation Inertia and Nominal Rigidities”.

I spent nine weeks at the HKIMR in the summer of 2003, between 21 July and 19 September. The original suggestion to apply had come from Paul McNelis of Georgetown University, whose visit in fact then overlapped with mine for several weeks, and with whom I started a very exciting new research project during that time. This was my first ever visit to Hong Kong, but certainly not my last, because I had a highly positive experience both professionally and away from work. I have since been highly recommending the HKIMR to colleagues in my field.

By way of background, I have been an assistant professor at Stanford University since 1998, specializing in International Finance. Prior to arriving in Hong Kong I spent a full two years on leave in Washington, DC, at the IMF and the Inter-American Development Bank. Just after returning from Hong Kong I resumed my teaching duties at Stanford.

The main paper I worked on during my nine weeks at the HKIMR is called “Inflation Inertia and Nominal Rigidities”. This paper is in the tradition of the New Keynesian monetary dynamic general equilibrium models. It tries to address some of the shortcomings of that model class, most importantly its inability to generate inflation inertia without introducing ad-hoc backward-looking pricing specifications. I work instead with a more general pricing specification than the conventional models, and embed that in a highly multi-sectoral model that is very successful at reproducing the impulse responses to monetary policy shocks. It is also quite complex, with over



100 equations. I completed the structural model at the HKIMR, and am still working on some quantitative aspects to do with impulse response matching. Completion is expected in early 2004.

At the same time I continued work while at the HKIMR on a very exciting project with the title “Fiscal Policy and Price Level Determination under Financial Market Frictions”. This is a model that attempts a meaningful integration of monetary and fiscal theories of price level determination, based on a set-up where the government jointly optimizes both policies. I find that when the financial market structure is such that large reductions in the real value of government securities disrupt intermediation and capital accumulation, it is no longer optimal for the government to use price level jumps (i.e. debt revaluations) to balance the budget in response to fiscal shocks, except when those shocks are extremely transitory. Instead labor taxes, even if distortionary, bear a major share of the fiscal adjustment burden. At the same time, the government is now able to levy an ongoing inflation tax on government debt, not just on money, because the long-run real financial return on government debt (and thereby the inflation rate) becomes endogenous to the labor tax decision. In other words, we have a “fiscal theory of inflation”.



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Conference: Deflation, Pegs and Capital Flows

The Institute co-organized a conference entitled “Deflation, Pegs and Capital Flows” with the Hong Kong Institute of Economics and Business Strategy of the University of Hong Kong and the Centre for Economic Policy Research (CEPR) in London on 1 and 2 December 2003.

This two-day conference was divided into four sessions with ten papers.

The first session was on the Argentine finance crisis in 2002. Charles Wyplosz of the Graduate Institute of International Studies, Geneva and CEPR looked at the “art of exiting a peg”. Mario Blejer of the Bank of England presented a paper entitled “Why the Argentine Currency Board Collapsed”. A panel session was



Panel discussion

formed to discuss Mario’s paper. It was chaired by Richard Wong of the University of Hong Kong. Panel members included Andrew Sheng of the Securities and Futures Commission of Hong Kong, Joseph Yam of the Hong Kong Monetary Authority, Charles Wyplosz and Mario Blejer.

The other three sessions were on price formation, deflation and capital flows which are current key issues facing Asian economies. Speakers included Hans Genberg of the Graduate Institute of International Studies, Geneva, Xavier Debrun of the IMF, H el ene Rey of Princeton University and Assaf Razin of Tel Aviv University and Cornell University.

In addition, a half-day hiking tour to Dragon’s Back in Shek O was organised for the speakers and panel members. The hike ended with a seafood lunch in Jumbo Floating Restaurant in Aberdeen.



Stefan Gerlach making some opening remarks



Assaf Razin delivering his paper



The hikers (from left to right): H el ene Rey, Stefan Gerlach, Xavier Debrun, William Branson, Petra Gerlach and Hans Genberg

Visiting Fellow – Michael Kumhof

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The conclusions of the paper are very important for emerging market economies, which often face debt sustainability issues and which then need to decide whether to resolve these through painful tax hikes, or instead through a painful burst of inflation. This paper shows what the tradeoff will be. It will be ready towards the early part of 2004.

In addition to these very productive research projects, I did of course also spend some time getting to know Hong Kong, being a first-time visitor. I was fascinated by its diversity, and most importantly by how friendly its people

are. I had a very happy experience and was sad to have to leave at the end of my visit.

As I mentioned above, I have been and will continue to highly recommend HKIMR as a place to do research. I should mention that this is especially true for economists working in International Finance, because during my time the number and caliber of people in that field at the HKIMR beat most US economics departments. [Editor’s note: Michael visited at the same time as Yin-wong Cheung, Michael Devereux, Salih Neftci, Charles Engel and Paul McNelis.]

Coming Activity

The Institute will co-organise a one-week workshop on "Advanced Modelling for Monetary Policy in the Asian Pacific Region" with the Centre for Central Banking Studies (CCBS) of the Bank of England in Hong Kong from 10 to 14 May 2004. This builds on a previous workshop held on this topic in 2002 (see photo below).



Recent and Coming Seminars:

8 January 2004 *Testing the Strong-Form of Market Discipline: The Effects of Public Market Signals on Bank Risk*, Simon Kwan (Federal Reserve Bank of San Francisco)

9 January 2004 *Assessing Deflationary Dynamics in Hong Kong with Linear and Non-Linear Regime Switching Models*, Paul McNelis (Georgetown University)

15 January 2004 *The Impact of Firm-Specific Characteristics on the Response to Monetary Policy Actions*, Paul Mizen (University of Nottingham)

5 February 2004 *Hong Kong's Exchange Rate Regimes in the Twentieth Century: The Story of Three Regime Changes*, Tony Latter (The University of Hong Kong)

12 February 2004 *Tunneling, Propping and Expropriation: Evidence from Connected Party Transactions in Hong Kong*, Stephen Cheung (City University of Hong Kong)

17 February 2004 *Robust Monetary Policy*, James Yetman (The University of Hong Kong)

19 February 2004 *Taking Two Steps at a Time: On the Optimal Step Pattern of Policy Rates*, Petra Gerlach (The University of Hong Kong)

Recently Published HKIMR Working Papers

No.2/2004 "Transfer Problem Dynamics: Macroeconomics of the Franco-Prussian War Indemnity" by Michael B. Devereux and Gregor W. Smith

No.1/2004 "The Relationship between Consumption, Income and Wealth in Hong Kong" by Joanne Cutler

No.24/2003 "Wage-Price Dynamics, the Labour Market and Deflation in Hong Kong" by Weshah A. Razzak

No.23/2003 "China: A Stabilizing or Deflationary Influence in East Asia? The Problem of Conflicted Virtue" by Ronald McKinnon and Gunther Schnabl

No.22/2003 "Bank Lending and Property Prices: Some International Evidence" by Boris Hofmann

No.21/2003 "Growth and Convergence in a Two-region Model: The Hypothetical Case of Korean Unification" by Michael Funke and Holger Strulik

No.20/2003 "Central Bank Governance: Common Elements or Different Models?" by Viv Hall

No.19/2003 "Asia's Debt Capital Markets: Appraisal and Agenda for Policy Reform" by Paul Lejot, Douglas Arner, Liu Qiao, Mylene Chan and Marshall Mays

and more please visit our web site.

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