

Feast and Famine: Explaining Big Swings in the Hong Kong Economy between 1981 and 2007

Chak Hung J. Cheng

The University of North Carolina at Chapel Hill

and

Michael K. Salemi

The University of North Carolina at Chapel Hill

Hong Kong Institute for Monetary Research

December 2009

Summary

On average between 1981 and 2007, output per capita in Hong Kong grew at an annual rate of 3.2 percent and the unemployment rate averaged 3.7 percent. But economic performance in Hong Kong over the period was far from even. Between the fourth quarters of 1981 and 1986, output per capita in Hong Kong averaged 10 percent below its long run value. Over the next 11 years through the end of 1997, the picture was much brighter. Output per capita averaged 9.7 percent above its long run average and the unemployment rate averaged 1.9 percent. But toward the end of 1997, the feast ended and famine began. Over the next 43 quarters, the unemployment rate averaged 5.8 percent and output per capita, employment per capita, and the real wage averaged 5.2, 3.1, and 1.8 percent below their respective long run values.

This paper attempts to explain the feast-famine cycle in Hong Kong. It asks what caused the Hong Kong economy to change from a period of exceptional economic performance where the unemployment rate fell as low as 1.0 percent to one of weak performance where the unemployment rate rose as high as 8.5 percent. It is not simply the case that Hong Kong suffered a recession. The average unemployment rate between 2000 and 2005 was 6.3 percent. Whatever happened to cause the feast to end and the famine to begin had not only dire consequences for Hong Kong but long-lasting ones.

We use two types of analysis to explain what happened in Hong Kong. First, we fit a nine-variable Bayesian Vector Autoregression to Hong Kong data. The chief finding of our BVAR analysis is that Hong Kong economic activity is greatly affected by several types of foreign shocks. Second, we set out and estimate a dynamic, general equilibrium model for Hong Kong. The chief finding of our DGE analysis is that the model can account, qualitatively, for the response of Hong Kong to the shocks that it experienced. We also use the model to gauge the relative importance of the shocks experienced by Hong Kong in accounting for the onset and continuation of its downturn.

We reach several findings. First, both our BVAR and structural model analysis indicate that the transition from feast to famine in Hong Kong that occurred in the late 1990's was the result of a "perfect storm" of negative shocks. Shocks to the risk premium associated with foreign borrowing and lending and shocks to export demand were two external factors that accounted for much of the big swing in Hong Kong economic performance. We find that shocks to nominal wages helped keep the unemployment rate low during the period of feast and also helped keep it high during the famine. Finally, we find that, in contrast with the standard real business cycle model, technology shocks played only a secondary role in the feast and famine cycle.