

# Hong Kong Consumer Prices are Flexible

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## Summary

It is received wisdom that prices in Hong Kong are flexible, and therefore that the presence of a currency board system, which precludes a nominal exchange rate adjustment in response to macroeconomic shocks, results in little cost to the macroeconomy. However, this belief in price flexibility is based on very little empirical evidence. In this paper, we seek to rectify this in a study of the behaviour of 327 sub-indices of the Hong Kong Consumer Price Index, and compare these with the predictions of four different models of business cycle propagation: flexible prices, capacity constraints (Hansen and Prescott 2005), menu costs (Mankiw 1985), and rational inattention (Levy et al 2004). We argue that each of these models has different implications for the size and persistence of price increases versus decreases, and that these vary between inflationary and deflationary periods.

We can identify many aspects of asymmetric pricing behaviour in our data, and also in the models that we consider. But with the exception of flexible prices, there is little agreement between the predictions of the models and the data. For example, menu costs imply that price decreases are more likely to be reversed by future price rises than vice versa, and the skewness of price changes is positively correlated with the inflation rate. We can reject the first of these hypotheses, and find no empirical support for the second. We therefore conclude that the menu cost model does not provide a good description of price setting behaviour in Hong Kong. Likewise, capacity constraints would imply that large price increases are more common than large declines, and that these large increases are more likely to be reversed, since they reflect binding capacity constraints that may be relaxed with time. These predictions receive mixed support in the data. And rational inattention implies that small price rises are relatively frequent, and persistent when compared with small price declines, neither of which receives any empirical support. In contrast, our predictions are broadly consistent with the predictions of a flexible price model, which predicts that price increases are larger and more persistent than price decreases during inflationary periods, while the reverse is true during deflationary periods. We thus conclude that, of the four models of price setting considered, flexible prices is the most accurate model of Hong Kong price setting.